UNIT 17 PROJECT EXPORT FINANCING

Structure

17.0 OBJECTIVES

After studying this unit you should be able to:

- explain the meaning of project export finance
- discuss the relevance and benefits of project export
- describe the Indian regulatory framework
- discuss the risks in project export business
- describe the various techniques of financing export project
- discuss the emerging trends in Indian export finance, special aspects of infrastructure export finance and international bidding and procurement instruments and arrangements.

17.1 INTRODUCTION

Project financing is a relatively new method of financing projects and facilities by capital-intensive industries. In a project financing the project, its assets, its contracts, its inherent economics and its cash flows are segregated from its promoters or sponsors in order to permit a credit appraisal and loan to the project, independent of the project sponsors. While in the final analysis lending to a project requires strong credit support from some source, frequently this support can be accomplished in an indirect or contingent manner which may have little or no impact upon the sponsor's debt capacity when compared to a direct borrowing. In some circumstances the credit of third parties unrelated to the sponsor can be used to support the credit standing of the project.

Project financing is an especially attractive financial vehicle in capital-intensive industries such as mining, petrochemical, forest products, utilities, steel production, heavy manufacturing and transportation. This is particularly the case with the energy and mineral extractive industries, where project financing has been widely used and is increasing in importance. Capital and lead time required to generate positive cash flows in a mineral extractive project, for instance, may militate against a project when compared to returns available from alternative commitments of capital by a multi-faceted company. Furthermore, some energy projects are so massive that joint development through use of a jointly owned project company is required in order to spread the capital requirements and the risks. Such ventures particularly lend themselves to project financing.

Over the past three decades India's exports have under-gone a distinct structural change from export of primary products to manufactured goods and then to project exports. Indian companies have undertaken projects in different parts of the world. The Middle East has been the boom arena for Indian project exports and they bagged contract after contract for everything - housing , bridges , roads, refrigeration, air conditioning, palaces, hospitals , dams, airports, mills, factories etc. In fact , the future of India's export trade depends on how fast and how best can India's performance in project exports can be further improved.

In this unit you will learn about the meaning, benefits, risks and techniques of project export financing. You will also learn about with the Indian regulating relating to project export financing, emerging trends, special aspects of infrastructure project export financing and international procurement and bidding process.

17.2 PROJECT EXPORT AND SERVICE EXPORT

Project Export

Project export is a term collectively used for :

a) Export of engineering goods on deferred payment terms

b) Turnkey contracts abroad on cash/deferred payment terms

c) Overseas civil construction contracts

The exchange control regulations relating to project export are contained in Memorandum of Instructions on Project and Services Exports (PEM) issued by Reserve Bank of India in May 1997.

Exports in respect of which payment are received within 180 days of goods leaving the port or services being rendered are called cash exports and if payments are received beyond 180 days it is termed as deferred exports.

Service Export

The export of services are the contracts for export of consultancy, technical and other services. In other words, contracts where there is no trade in goods or export of goods fall under this category. Generally these are :

a) Preparation of projects' feasibility reports, drawings, designs etc.

b) Supply of technical know-how, engineering services in different fields

c) Operation, supervision, maintenance of plants, buildings, structure etc.

d) Management contracts of commercial concerns

The exchange control regulations relating to service export are also contained in Memorandum of Instuctions on Project and Services Exports (PEM) issued by RBI in May 1977.

17.2.1 Difference between Project/Service Export Finance and Project Finance

Most often project / service export finance is mistaken as project finance. In case of project finance, the financial requirements for the underlying project are considered in detail whereas project export finance is only confined to assisting the contractor who undertakes to execute the project. However , it is equally important to know by whom and how the underlying project will be financed so as to ensure that the contractor recovers his receivables under the project without any difficulty. The difference between project finance, export finance and project export finance can be understood more clearly as under:

Project Finance	:	Finance for long term capital expenditure.
Export Finance	:	Finance cash exports, i.e. where payments are received within 180 days .
Project Export Finance	:	Financing Indian exporters who intend to execute project or undertake service contract or supply goods on deferred terms.

17.3 BENEFITS OF PROJECT EXPORT

A Financial Benefits

a) It is an avenue for earning considerable foreign exchange with use of minimum domestic resources.

b) Besides project exports, it involves export of technical services and skilled and unskilled manpower.

c) Purchase of equipment for execution of the project is paid through foreign exchange from the project.

d) In project exports, credit facilities granted by banks are self liquidating in nature. Non- funded bonds are guarantees for bulk of credit facilities required.

e) It is a vehicle for capital equipment and material exports.

f) Banks are normally required to provide funding support only for a fraction of the working capital needs of the project.

g) Project exports provide opportunities for skilled as well as unskilled man-power to work in foreign countries and repatriate valuable foreign exchange.

h) Project exports generate a ready market for construction and building materials, plants and equipments and associated services, thus providing avenue for added earnings in foreign exchange.

B Non-financial Benefits

a) Undertaking projects in foreign countries fosters good relationships between home and the host countries.

b) Carrying out projects abroad enables absorption of the latest international technology and to appreciate the versatility of the state of art engineering and construction equipment.

17.4 RISKS IN PROJECT EXPORT BUSINESS

In executing a project export, the exporter is exposed to various attendant risks like commercial risks, country risks and exchange and interest rate risks.

17.4.1 Commercial Risk

The commercial risk arises from the inability of the project buyer to make payment even after full and satisfactory completion of contract. This risk is linked to the creditworthiness of the buyer and the source of funding for the contract. Large value contracts in developing countries are normally funded by Official Developing Agencies (ODA) like World Bank, Asian Development Bank, etc. In ODA assisted contracts, the payment are made on contract completion and deferred payments are not involved.

It is quite common in project exports to extend commercial credit for medium to long terms. The exporter should have the creditworthiness of the buyer established before allowing credit terms for exports. Banks with the assistance of their foreign offices as well as correspondent banks can get the trade/credit information required by the exporter.

To ensure payments of supplies made exporter can resort to irrevocable letter of credit (IL/C) or bank guarantee (BG). However , for buyers of unblemished payment record with whom exporter has sufficient past experience, requirement of ILC/BG can be waived.

Commercial risks can also be covered to some extent by taking comprehensive risk coverage policy from Export Credit Guarantee Corporation of India Ltd.

17.4.2 Country Risk

Country risk is broadly a risk that arises out of political, social and economical factors prevailing in the country of import and having a bearing on the country's ability to honour its cross-border obligations. At times, although the importer (private or public sector) in a country is able to honour his payment obligations domestically, he is prevented from doing so on account of the macro factors stated above in his country. In other words, the importer's capacity to pay cannot be the only criterion for undertaking exports to his country. What also matters is the country's ability to meet its external obligations for which it must have adequate foreign exchange reserves.

There are several sources from which an exporter can access up-to-date information regarding the political, social and transfer risk situation obtaining in most of the countries in the world. Dun & Bradstreet publish such information on over 100 countries. Other agencies also publish profile on various countries regularly for the use of investors, bankers and exporters. For example, Moody's, Standard & Poor's and institutional investors assess and publish country ratings that are revised from time to time in tune with their perceptions of such risks. The exporters, on the basis of their first hand experience gained during visits to the country of the importer and the data available from the credit rating agencies, need to decide about entering into a new market abroad.

In view of the large stakes involved, the project exporters, in particular, would benefit themselves enormously by a careful assessment of country risk before undertaking export contracts. A detailed examination of country risks assumes importance for large value contracts spanning over a longer period. Infrastructure projects are highly vulnerable to social/ political environment.

Over the years, the experience gained in execution of a number of contracts in several countries by the project exporter will make the understanding of country risks better. ECGC policy cover also takes care of country risks subject to certain limitations.

At the time of adding confirmation to L/Cs opened by foreign banks, accepting draft drawn under L/Cs and issuing guarantees/bid bonds against the counter guarantee of the foreign banks (i.e. assuming exposure from Indian bank), Indian banks do consider whether the bank/country is placed under "caution". The credentials of the L/C opening bank and the transfer risk involved are considered by the bank. Sometimes a confirming bank may require Transfer Guarantee (political risks or comprehensive risks) provided by ECGC, the cost of which is to be borne by the exporter.

17.4.3 Exchange and Interest Rate Risk

An exporter is exposed to exchange and interest rate risks when the currency of payment and interest terms on the credit provided for the contract are different from the currency and interest terms of his borrowing. Normally, deferred credit offered by the exporters to the overseas buyer carry fixed rate of interest and exporter's borrowings to fund the deferred credits are subjected to floating rate of interest. This mismatch results in interest rate risk.

Besides the above risks which can be hedged against by the project exporter, others can not be avoided. Further there can be unforeseen risks on account of which the profitability can be reduced. Therefore at the start of the project, profitability of the project should be high, say more than 10% of the project cost.

17.5 INDIAN REGULATORY FRAMEWORK

Project Export Manual (PEM) issued by RBI contains various regulatory provisions in detail relating to Project/ Service Export. Important provisions are summarised below.

17.5.1 Criteria for Consideration of Project Export Proposal

1) Undernoted aspects should be examined by the Authorised Dealers/approving authority while considering proposals of project export for approval.

   a) Geographical, climatic, political and economical conditions of the importing country and creditworthiness of the buyer.

   b) Experience, financial position and competence of the exporter and his sub-contractors; if any,

   c) Immediate and long terms foreign exchange earnings for the country.

   d) Terms of payment, adequacy of advance payment, period of deferred credit offered vis-à-vis competition, rate of interest thereon, requirement of foreign exchange.

   e) Security available against payments receivables vis-à-vis the extent of advance payment guarantee, performance guarantee etc. to be issued.

   f) Escalation / penalty / governing law clauses.

   g) Extent of fund based / non fund based facilities required in India.

2) Proposal for civil construction contracts are to be considered only from contractors who are on the approved list of Ministry of Commerce, Government of India. Tenderers who are not on the approved list should first approach the Screening Committee set by Ministry of Commerce for getting their names included in it.

17.5.2 Conditions Necessary for Clearance of Project Export Proposal

a) **Advance payment :** Advance payment / down payment / mobilisation advance provided by overseas buyer is an important source of working funds required for contract execution. A minimum level of advance / down payment to the value of the contract has been stipulated in PEM as under :

TYPE OF CONTRACT	ADVANCE PAYMENT
PROJECT EXPORT	
Turnkey Civil Const. Contract	15%
Deferred Payment (Supply) Contract	15%
SERVICE EXPORT	
On Cash Terms	15%
On Deferred Payment Terms	25%

However, in exceptional cases, this may be reduced to 5% of the contract value.

b) **Forex outgo :** Foreign exchange outgo is the amount remitted abroad or paid in India which is convertible into foreign currency. This includes agency commission and royalty payable; freight payable in foreign currency; value of import replenishment and cost of third country imports. For turnkey / civil construction contracts foreign exchange outgo (which is foreign exchange outgo less advance payment/down payment) should not in any case exceed 25% of the contract value.

c) **Agency commission :** The payment of agency commission at the following rates is allowed for project / services exports:

TYPE OF CONTRACT	AGENCY COMMISSION CEILING
Deferred payment	10%
Turnkey / civil construction	7.5%
Services contract	12.5%

Higher rates of agency commission can be approved by RBI i.e. upto 12.5% for pure supply contracts and 10% for turnkey contracts. Earlier such commission was payable on pro-rata basis of payment from the buyer but now RBI has allowed advance payment of commission out of project funds.

Bridge finance : Normally the turnkey projects and construction contracts should be self financing by way of advance / down payment and progress payments received during the execution period. Exporter, therefore, should not require bridge finance as no cash flow deficit should occur. However, to meet temporary shortfalls in the working capital, bridge finance can be extended up to an extent of 15% of the contract value. Ordinarily no credit should be provided in respect of services segment of a turnkey project, but in special cases it could be considered on the same basis as supplies.

d) **Deferred credit :** Anticipated life of the goods to be exported, extent of foreign competition, nature of the foreign market and the contract value should be taken into consideration while determining the terms of the deferred credit.

Maximum permitted credit periods including grace period for capital / producer goods and turnkey projects are as under :

Project Export Contracts :

CONTRACT VALUE	MAXIMUM CREDIT PERIOD	
	Capital goods	Turnkey projects
Up to Rs. 10 lacs	3 years	4 years
> Rs. 10 lacs but < Rs. 50 lacs	5 years	6 years
> Rs. 50 lacs but < Rs. 1 crore	8 years	9 years
> Rs. 1 crore	11 years	12 years

Service Contracts :

Up to Rs. 20 lacs	No credit
> Rs. 20 lacs but < 3 crores	3 years
> Rs. 3 crores but < Rs. 5 crores	4 years
> 5 crores	5 years

In case of civil construction contract on deferred payment terms, the period of repayment should not exceed 5 years including period of moratorium.

Moratorium on repayment of principal (and not interest) : Not more than 1 year for supply of goods / services and 2 years for turnkey projects. Interest should be payable even during the moratorium period.

The computation of the moratorium period is done with reference to the following dates :

(a)	for supplies	..	mean date of shipment
(b)	for turnkey projects	..	date of contract or mean date of shipment or commissioning as agreed between the parties

Interest rate : Interest rate payable on the deferred credit should normally cover the cost of post-shipment finance.

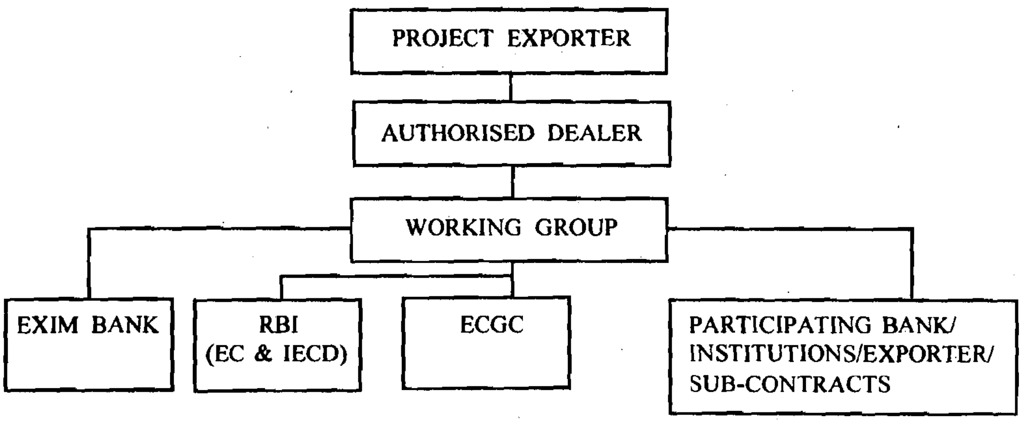
Security for the extension of deferred credit : Deferred installment should be secured by L/Cs or acceptable bank guarantee. If the buyer is a government department or a public sector undertaking, guarantee from the foreign government and /or promissory notes from the foreign government / public sector undertaking may be accepted.

17.5.3 Working Group Mechanism

Exporters undertaking project / service export are required to obtain approval from different institutions besides their own bankers before making bid / proposal to overseas buyer. With a view to obviate the need for exporters to approach each institution separately for approvals and to avoid delays, a Working Group (WG) has been constituted for the purpose of giving package approval. Working Group is a body consisting of EXIM Bank of India as Chairman, Reserve Bank of India (Exchange Control and Industrial and Export Credit Departments) and ECGC as members.

All project export proposals of value more than Rs. 100 crores and service contract of value more than Rs. 10 crores are required to be cleared by WG. Proposals of value less than the above amounts are to be cleared by the EXIM Bank / Authorised dealers, i.e. sponsoring bank as per power delegated to them.

The project export proposals of high value falling beyond the powers of AD / EXIM Bank are cleared through Working Group mechanism that is given below.



Role of the Working Group Participants

Authorised Dealer	:	sponsoring and financing agency
EXIM Bank	:	nodal agency for project exports and financing
RBI	:	regulatory agency with powers for approval of forex/ credit requirements
ECGC	:	insurance agency
Financial Institutions	:	funding / participation agencies

17.5.4 Power for Clearance of Project Export

From exchange control angle, all proposals of project export have to be cleared before bidding. The authority structure for clearance of project export proposals is as under ;

	Project Export	Service Export
Authorised Dealers (AD)	Up to Rs. 25 crores	Up to Rs. 5 crores
EXIM Bank of India	Above Rs. 25 crores and up to Rs. 100 crores	Above Rs. 5 crores and up to Rs. 10 crores
Working Group	Above Rs. 100 crores	Above Rs. 10 crores

No clearance from ADs, RBI or Working Group is required for service contracts if it is on cash terms and no facility is required by exporter.

Project involving buyer's credits and export of managerial / technical consultancy services involving fund-based or non-fund based facilities with deferred payment terms must be referred to Working Group.

Project exporters should submit their applications to their bankers in the applicable format in ten copies at least ten working days before the last date of submission of the bid to overseas buyer. The formats of these forms are provided in PEM.

DPX-1 - Application for export of engineering goods on deferred payment and turnkey contracts.

PEX-1 - Application for submitting tender / offers for managerial / technical / consultancy service contracts abroad.

Authorised Dealers should examine the proposal in the light of factors enumerated above and verify that the conditions listed in paragraph 17.5.2 are satisfied. If the amount of the proposal falls within the powers of the authorised dealer and he is in a position to extend the credit facilities required by the exporter without the assistance of EXIM bank, AD should grant clearance in principal. Thereafter, AD should forward copies of the application together with a letter of approval promptly to each of the following institutions :

a) Office of Reserve Bank (ECD) within whose jurisdiction the Head / Registered Office of the exporter is situated

b) Central Office of Reserve Bank (ECD), Mumbai

c) Central Office of Reserve Bank (IECD), Mumbai

d) ECGC, Mumbai

e) EXIM Bank, Mumbai

In other cases i.e. where the value of the proposal is beyond the powers of the AD and/ or the proposal does not satisfy the necessary conditions (i.e. the contract terms containing deviations from RBI guidelines), AD should send four copies of the application to EXIM Bank and one copy each to the other institution mentioned above alongwith his detailed comments and recommendations on form DPX-2/ PEX-2/ TEX-2 as the case may be. AD should also mention the extent upto which his bank would be prepared to take a share in the credit facilities required by the exporter.

WG, when it approves proposals under its powers, accords one window clearance on behalf of ECGC, EXIM Bank and RBI (ECD and IECD). In approved cases a package approval in principal will be granted by EXIM Bank on behalf of WG. In other cases where AD or EXIM Bank clear proposal under their discretionary power the onus of obtaining ECGC'S concurrence prior to such clearance lies on the ADs and EXIM Bank. Similarly, if for proposals under ADs powers, EXIM Bank participation is required, prior EXIM Bank clearance would be necessary.

Needless to add that when ADs find that the terms of the proposal (falling under their powers) do not conform to the guidelines laid down in the PEM, they should refer the matter to EXIM Bank / WG for prior clearance.

Time Limit for Clearance of Project Export Proposals

Authorised Dealer	:	should submit recommendations to the working group within 5 days of the submission of the applications.
Working Group	:	package approval will be given by EXIM Bank within 7 days of receipt of the completed applications.

Exporter should submit his application in ten copies to his bankers in form DPX-3 or PEX-4 , as the case may be, within 15 days of signing the contract alongwith eight copies of the contract. In the event of deviations from the project the bid stage, specific approvals may be required from Ads / EXIM Bank / Working Group for the changes depending upon the nature of changes. Normally for significant changes, the exporter obtains necessary approvals prior to signing the contract for execution of the project. The sponsoring bank has to obtain their internal approval for supporting the contract at post award stage taking into consideration the changes that have taken place in contract terms, country risk perception and exchange control regulations. If any.

All Indian sub-contractors must apply to the bankers of the prime contractor for obtaining approval for their respective shares of the job.

Check Your Progress A

1 What do you understand by project export finance?

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....

....

....

2 List the various types of risks in project export finance.

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....

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3 List out factors as required by RBI before sanctioning project export finance proposals?

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17.6 TECHNIQUES OF FINANCING EXPORT PROJECTS

Finance is the crucial determinant in success of the project exports. Financing of overseas projects refers to the arrangement of adequate funds to finance the development and construction of a specific project. The particular way in which finance is arranged will depend upon the type of development expected and will vary from project to project and country to country. The lending institutions have to satisfy themselves with the examination of social and political situation within the project buying country and the ability of the economy to generate sufficient foreign exchange earnings to repay the loan. They also consider the extent of its existing exposure and viability of proposed project.

Some projects may be part self-financing and part government sponsored, while others may involve the participation of major corporations possibly in partnership with a government entity. Further, the project may itself qualify for funds from a wide variety of sources including commercial banks, export credit agencies, development agencies (like World Bank, IBRD, IDA Asian Development Bank, African Development Bank etc.), bilateral aid or indeed any combination of these. Such considerations make it necessary to examine all the available modes of funding so that sponsor can obtain the best mix of financing facilities.

Possible sources for loans and equity for project financing include :

1 international agencies
2 government export financing agencies
3 host governments
4 commercial banks
5 institutional lenders
6 money market fund
7 commercial finance companies
8 leasing companies
9 wealthy individual investors
10 Insurance compnies
11 companies which supply a product or raw material
12 companies requiring the product or service produced by the project
13 contractors
14 trade creditors
15 vendor financing of equipment and
16 sponsor loans and advances.

These possible sources for loans or equity capital can be divided into two groups of lenders and sponsors :

1 **Commercial lenders :**
   a) banks
   b) institutional investors (local market for equity and bonds);
      (i) insurance companies, and
      (ii) pension funds;
   c) commercial finance companies
   d) leasing companies
   e) individuals
   f) Insurance companies

2 **Commercial sponsors :**
   a) companies requiring the product or service
   b) companies supplying a product or raw material to the project
   c) international agencies;
      (i) The World Bank, and
      (ii) Regional development banks
   d) government export financing agencies :
      (i) export-import banks, and
      (ii) other government agencies
   e) host government :
      (i) government agencies, and
      (ii) a central bank
   f) contractor
   g) trade creditors and
   h) vendor financing of equipment.

Let us now discuss each of these sources of project export financing.

The World Bank and Regional development banks

The World Bank and area development banks provide debt, or a mixture of equity and debt, for project financing.A World Bank loan or an area development bank loan have certain advantages :

a) The loans tend to be for longer terms than might otherwise be available. Fixed interest rates may be possible.

b) The interest rates tend to be lower than would otherwise be available. Fixed interest rates may be possible.

c) Participation of the World Bank or regional development bank endorses the credit for other potential lenders.

d) A co-financing arrangement or a complementary financing arrangement may be possible, whereby commercial bank loans are linked with the World Bank or regional development bank loans, with cross-default clauses.

Government export financing

Export financing from government export agencies is generally available from two sources, or a combination of both :

a) an export-import bank, and

b) foreign aid.

Foreign aid, in turn comes in two forms ;

a) from the private sector of the country , where the government is providing the aid; and

b) from the sources from which the recipient purchases goods and services.

Nearly all such foreign aid must be used to purchase goods and services from the private sector of the country providing the financing.

Government export financing has the following characteristics.

i) **Loans and guarantees**

Export agencies provide support in the form of loans and guarantees, or in a combination of both. The US Export-Import Bank, for example, itself provides funding and guarantees. The export-import banks in some countries provide a guarantee of the financing, which is then used to secure a loan from the regular a commercial banking sources of the country.

ii) **Supplier credit**

In a supplier credit, a loan is made to the supplier, and the supplier quotes financing terms to the purchaser. Supplier credits usually require the supplier to assume some portion of the risk of financing although as a practical matter the supplier's profit margin may exceed the risk assumed.

iii) **Buyer credit**

In a buyer credit financing the loan is made to the buyer instead of to the supplier.

iv) **Typical terms**

a) Five to Ten years
b) Low interest rate compared to commercial sources
c) Currency normally in the currency of the supplying country, but any other currency may be used

v) **Fees**

A fee of 1/2 – 1% per annum is typically required.

Host Governments Assistance

Host government will sometimes provide the following direct and indirect assistance :

a) government equity investment by government investment companies ;
b) investment grants ;
c) government subsidised loans to support new enterprises in depressed areas ;
d) income tax concessions or real estate tax concession (while these are not a direct infusion of capital, they have the same effect by reducing cash flow needed for operating expenses ;
e) concessions on royalties ;
f) subsidised energy costs ;
g) subsidised transportation ;
h) subsidised communications ;
i) subsidised employee services such as school, hospitals, and health services ; and
j) local services, roads, water, sewer, and police protection.

Commercial banks

Commercial banks are the largest source for project loans. Commercial banks tend to limit their commitments to five to ten years with floating interest rates based on Libor or US prime rate. From time to time loans for longer terms are available. Fixed interest rate loans for five to ten year maturities are sometimes available. Commercial bank loans for large projects are typically arranged as syndicated bank loans.

Institutional lenders

Institutional lenders including life insurance companies etc.

Commercial finance companies

Large commercial finance companies are a potential source of funds for financing. Compared to banks or insurance companies, finance companies do not have a depositor base or policy-holders as a source funds. They must buy all their funds in the debt markets and re-lend at a spread. Consequently funds from finance companies tend to be highly priced and limited in volume.

Leasing companies

Leasing companies, which use tax benefits associated with equipment ownership, offer attractively-priced leases for equipment. Independent leasing companies, and leasing companies owned by banks and finance companies, are an important source of loans and leasses.

Suppliers of raw materials

A supplier seeking a market for a product or a by-product which it produces is sometimes willing to subsidise construction, or guarantee debt of a facility which will use that product.

New product buyers of service users

A corporation requiring a product or a service may be willing to provide financial help in getting a project built. Generally this help will come in the form of a long-terms take-and-pay contract, or a through-put contract. Take-or-pay contracts or through-put contracts are the equivalent of guarantees, and can be used to underwrite loans from commercial sources.

Contractors

Contractors, while often enthusiastic about a proposed project financing, are rarely able to participate significantly in the long-terms financing of a project. However, contractors can provide support in the form of fixed price contracts, which are the same as guarantees to build a project facility at a certain price. Contractors will, on occasion, agree to take a portion of their fees as an equity interest in a project.

Contractors can sometimes be of great help to their customer by providing advice on the financing of projects, having had considerable expertise in dealing with lenders, potential sponsors and various government agencies which may be sources of funds for projects. They may also be able to suggest structures and methods for project financing.

Trade creditors

Trade creditors wishing to do business with a project company will extend short-term credit linked to the sale of goods and services.

Vendor financing of equipment

Many dealers and manufacturers have extensive financing programmes to encourage the sale of their machinery and equipment. Domestic dealers and manufacturers often compete with export financing provided by foreign competitors , and credit terms and criteria may, as a result, be somewhat relaxed. This type of financing has been increasingly available in recent years, and is an important source of funds for project financing. Long-term warranties of equipment reliability and performance from manufacturers are helpful in arranging financing from other sources.

Build-Operate-Transfer (BOT) / Build-Own-Operate-Transfer (BOOT)

The nature of infrastructure projects and their inherent complexities make them different from traditional industrial projects with which the financial institutions (FIs) have been familiar. Most of the projects adopt new techniques such as BOT/BOOT. In addition to traditional financial, technical and economical appraisal capabilities of project financing, infrastructure projects require deep understanding of the legal, regulatory and institutional arrangements under which the project promoters would operate. Most infrastructure projects are non or limited-recourse financing and hence bear higher risk compared to traditional industrial lending where the risk is covered by the balance sheet of the sponsor, with tangible assets as security.

The concessionaire approach has been adopted recently by many developing countries for attracting private sector funds for infrastructure development. The most prominent and possibly the most widely used, is the Build-Operate-Transfer (BOT) arrangement. As the term suggests, the private investor (concessionaire) builds, operates and transfers the facility back to the Government at the end of a specified period, called the concession period. A transparent regulatory framework is needed a make BOT arrangment to work smoothly.

17.7 INDIAN PROJECT EXPORTS : EMERGING TRENDS

International projects market depends mainly on the international economic environment. It moves with the recession and recovery in different countries; the best thing about which is that economic cycles are not highly corelated between and among countries. Neverthless contagious effect does occur. A slow down in U.S. economy does effect Indian exports. However India has succeeded in project exports in Middle East, Africa and South Asian countries.

The construction / modernisation is the biggest growth industry in the Middle East. The development of Arab and African world in warehousing, transportation, agriculture, industry, mining etc. would take decades in terms of time and hundreds of billions of dollars worth of construction projects and their national construction agencies / industries cannot yet meet these needs. That is why the region will continue to be lucrative and attractive market offering considerable scope to foreign contractors and consultants. The increasing requirement of higher technology and the benefits of utilising the services of foreign companies are quite evident to these countries. It is estimated that the value of current output in Middle East is more than 100 billion dollars per year, which makes the Arab construction market the third largest in the world (after USA and Japan who spend more than this).

The area of hope is still Middle East, Arab and Africa. Breakthroughs elsewhere will not be easy because of severe competitions from Japanese. Koreans and Chinese companies, in fact, are grabbing the projects at any cost and in some cases even at a loss. Vietnam and Thailand are looking for aid-linked projects. The scenario is not that gloomy provided the country gears up to avail of the emerging opportunities as stated above. With the result, demand on export credit as well a other facilities extended by EXIM Bank / commercial banks would also go up.

17.8 SPECIAL ASPECTS OF INFRASTRUCTURE PROJECT EXPORT FINANCING

Indian companies have undertaken large number of projects in the generation of power in South East Asia, West Asia and African countries. Indian contractors have successfully executed high value construction projects encampassing palaces, buildings, hospitals, dams, airports in West Asia. Indian engineering goods have been exported to more than 60 countries. These have included transmission line towers, vehicles, plant and machinery for the manufacture to textiles, sugar, cement, pulp and paper, chemicals and pharmaceuticals, are but some examples. Indian industry is able to offer expertise in design, construction, installation and operation in the fields of :

a) Fertiliser and chemical complexes

b) Oil refineries and downstream Petrochemical complexes

c) Power generation, transmission and distribution

d) Sugar, textile, cement, paper plants

e) Integrated steel plants

f) Water treatment and waste treatment plants

g) Port harbour development

h) Road and highway construction Railways

i) Township construction

j) Telecommunication systems

k) Luxury Hotels etc.

The financial success of many project financings depends on the future existence of a market for the product, commodity or service produced or furnished by the anticipated cash flows necessary to service debt, cover operating expenses and provide a return to the equity investors. Market surveys should provide a basis for the anticipated volume and price of product, commodity or service to be produced. Internal marketing surveys prepared by the sponsor should be supported by independent marketing studies. Competing products, and competition from suppliers closer to the markets, or with less expensive sources of raw materials, feed stocks or energy should be carefully studied. In the context of financing of infrastructure projects, following aspects need to be carefully studied as the cost of error of judgement in the case of infrastructure projects can be enormous.

Transportation of Product to Market

Transportation costs for moving the product from the project facility to the market must be assured at a cost consistent with the financial projections. The method of transportation — whether by rail or ship-must be reviewed, together with the necessity for constructing any facilities needed for transportation, such as roads, railroads, harbours, docks, pipelines warehouses of airfields. The vulnerability of the project to future increase in transportation costs by companies controlling the only feasible means to move the product to market must be taken into account. Long-term transportation contracts (with appropriate escalation clause) may solve this problem.

Adequate Communications

Adequate telephone equipment and / or communications equipment is essential to any project. Telephone calls may take time to get connected in many parts of the world. Apart from frustration at such inadequacies, poor communication facilities result in costly delays in decision-making and in accomplishing objectives. The cost of providing radio/ telephone communication should be taken into account for projects in remote locations.

Availability of Building Materials

Building material to be used must be available at a cost consistent with the estimated construction costs. The cost of transportation and the availability of local sources for building material should be considered where possible. Contingency plans should be made for the possible use of alternative building materials. The ability to import building materials, manufactured goods and machinery needed for the project must also be established. Any import fees or duties should be reasonable. Projects often encounter difficulties because of inadequate planning for building materials, for example, relying on the availability of local supplies of cement, only to discover later that local supplies of cement are unavailable for some reason, with the result that cement has to be imported from long distances, at excessive cost.

Experienced and Reliable Contractor

The expertise and good reputation of the contractor who is to construct a project facility must be well established. The contractor must have technical expertise to complete the project, so that it will operate in accordance with cost and production specifications. Ideally, the contractor should be a company which has previously successfully built similar projects. The contractor should be financial strong since the financial failure of a contractor is a disaster few projects can survive. The contractor should also be resourceful enough to have the resources to devote to, and solve, any problems which might arise. Contractors to a project, to be located in a developing foreign country, must have experience in doing business in that country or in that part of the world. Even experienced contractors with good reputations have run into difficulties where they were unfamiliar with the climate, culture, government infrastructure and the geographic circumstances of a particular project.

The contract, or a subcontract, in a project financing should not be awarded on the basis of a low bid unless the low bidder satisfies the criteria outlined above.

Experienced and Reliable Operator

The operator must have the financial and technical expertise of the project in accordance with the cost and production specifications which form the basis for the financial feasibility of the project. The operator may be an independent company specialising in providing such a service. Alternatively, the operator may be the promoter, or may be one of the sponsors or co sponsors of the project. In any event, personnel with experience and expertise in operating similar projects at other locations is essential.

Management Personnel

Good management personnel as well as experienced operating personnel are needed to operate a project. The general management of a project company takes the basic policy decisions, arranges the financing provides information to lenders and investors, and is responsible for monitoring and administering the project company. The management team must be experienced, reliable, and have a good working relationship with the project lenders. The sponsors must be able to attract and retain a good management team.

No Untested and Unproven Technology

The project should not involve untested and unproven technology. The reliability of the process and equipment to be used must be well established. If new technology is involved, more than a lending risk will be involved, unless the project borrowings are guaranteed by a strong credit such as a government agency.

If a project is to be largely self-supporting without an all-encompassing guarantee from a government agency or some other form of credit cover lenders will insist that the project uses existing technology.

Contractual Agreements among Joint venture Partners

If the project is a joint venture the agreements between the joint venture partners are of considerable concern to lenders, who want assurance as to the identity of the companies and entities which will own and operate the project throughout the life of the loan. It is of particular concern that joint venture agreements contain satisfactory provisions on :

a) changes in precentages share of participations by any of the partners ;

b) withdrawal and replacement of partners ;

c) addition of new partners ;

d) responsibility rights, and obligations of partners to each other if one partner fails to meet its financial obligations or commitments to the remaining partners ;

e) procedure for settlement of disputes among partners ;

f) voting rights of the partners on operation and management of the project ;

g) assurance that the project facilities will be managed by a qualified operator for the life of the loan, particularly where the host country increases its ownership participation.

Political Environment, Licences and Permits

The political environment for the location of the project, and the type of project, must be reasonable friendly and stable. Any necessary permits must be readily available, and restrictions must be realistic. It must be possible to develop good working relationships with the government officials who will be involved with the project.

The need for a stable political environment is not confined to projects located in developing countries. In recent years, a stable and friendly political environment has not always been assured for projects located in North America and Europe also. Hundreds of licences and permits may be required to build many kinds of projects in the United States, and some of these licences and permits are not available until after completion of the project for instance, certain clean air and clean water licences and permits. A lender to a project must be assured that such permits will be granted in a fair and objective manner, based on standards which are known at the outset of the project.

No Risk of Expropriation

Expropriation can be direct or indirect, it can be fast or creeping. However, as far as lenders or owners are concerned, the result is the same. The risk of direct expropriation in a developing country is fairly obvious. The risk can be appraised by examining the infrastructure of the country, its neighbors, its history and its power structure. The hard questions which have to be answered are : who will be the likely new head of state in the event of a political change, revolt or an invasion, and what will their attitude be towards the project, payment of the project debt, and living up to the agreements of the preceding government regarding the project?

Country Risk

Country risk is usually defined as a risk of a lender making a cross- border loan to a private company. Country risk problems occur when the host country is not in an economic position to permit transfer of amounts of currency for payment of interest and principal on foreign debt to lender. Country risk problems also occur when the country has an embargo on certain products, or will not permit repayment of debt, for domestic foreign policy reasons.

Sovereign Risk

Sovereign risk differs from country risk in that it refers to the risk of a loan to a sovereign nation by a lender located in another country. This has application in project finance where the sovereign nation is one of the investors or joint investors in the project of a loan to the project which is in part, at least, a loan to the nation. Financial advisors or lenders to a project can help sponsors to appraise and consider this risk.

Currency and Foreign Exchange Risk

Currency risk problems arise where revenues, expenses, capital expenditures and loans are in more than one currency and, therefore, subject the project to potential losses from currency fluctuations. Where this problem exists, strategies must be devised to match currencies or cash to be received in the future with cash required for future payments. During construction, lenders will look to the sponsors to make up any foreign exchange losses by providing additional funding.

Careful analysis must be made of the expected cash flow of a project to determine what currencies will be used to finance the project, including the host country currency, and what currencies will be generated by the project. The exchange of one currency into another must be carefully managed. Hedging in forward currency markets should be done where possible at a reasonable cost. Hedging for the commodity produced may be possible, as may forward currency sales and swaps. A multi-currency loan may help control this risk. The bank or financial advisor to the project can provide expert advice and help in these problems.

If the project is located in a developing country , the rights and obligations of the project company to deal in local or foreign currencies should be spelled out in some kind of concessionary agreement with the central bank of the host country. Artificial conversion rates can, of course, significantly affect the project adversely.

Adequate Equity Contribution

The key project sponsors or promoters must make equity contributions consistent with their capability, interest in the project, and risk of the project. Lenders will require the sponsors of a project to have a sufficient financial interest in the project so that it will be difficult for the sponsors to abandon or ignore the project.

Enterpreneurial companies, however, are often the sponsors of projects. They like the leverage of project financings, and they like the potential profits. However, such companies seek out new opportunities, and should one of their investments not work out as expected, there may be a tendency to neglect or forget about that project, to concentrate on one with more promise. Lenders would not want sponsors to have that option.

The Project as Collateral

Lenders may be willing to rely to some extent on project facilities and properties as collateral and security for debt repayment. Therefore, in planning a project, it is important to try to locate and structure the project and its facilities so that they may have value to third parties. To the degree that this objective can be accomplished, less debt support may be required from lenders. It may however be noted here that the project must be primarily support - worthy in terms of cash flows.

Independent Appraisals

Independent appraisals of project resources, particularly in case of oil or mining projects, must be available.The value of such reserves, of course, can play a major role in the project financing.

The risk in a resource project is that the actual production and the revenue derived from it will be insufficient to pay operating costs and amortize project debt in accordance with the financial plan, if actual reserves are lower than estimated.

Cost Over – Run Risk

Cost over-run risk occurs when the cost of construction or completion of a project facility is larger than originally estimated. This creates servious problems in a project financing. Unless the remaining construction costs are paid, the facility will not be completed, and the project will not generate funds to repay project debt. This puts the entire project in jeopardy. A delay in completion of a project facility creates a compound problem. Interest on the construction loan continues to run, thus raising the capitalized costs of the project and resulting in a cost over-run. At the same time, the expected stream of revenue is delayed since the plant cannot operate to produce the product or service. If the delay continues for any lenght of time, cost of labour and materials increases due to inflation.

If not provided for, such a development puts considerable pressure on lenders to advance additional funds. In order to properly mitigate this risk, the sponsor or contractors should be obliged to make up for cost overruns.

The sponsor or investors agree to come up with the additional capital, in case of cost over run. This additional capital is sometimes in the form of subordinated debt rather than a capital contribution, permitting return of the additional investment to the investors on some basis other than as dividends or a distribution of capital, which might otherwise be in violation of loan agreements.

Another method of handling an over-run is through a standby credit facility from the original lenders. In such a standby credit arrangement, additional borrowings may have to be covered by a lengthening of take - or - pay contracts, or price adjustment of the product of service. Under such an arrangement, additional guarantee of capital contributions by sponsors may be necessary.

Over-run risk can be guarded against to some extent if some form of fixed-price or turn-key contact can be obtained from contractors and subcontractors. In such an event, the contract price will be higher because of the higher risk for the contractor.

Lender's Take-out

The loan agreement can require the sponsor to purchase the assets and take out the lenders if the project is not completed and operating according to specifications by a certain date. As a practical matter, such an agreement sets the stage for lenders to renegotiate the loan on more favourable terms and conditions.

Sponsor's Escrow Funds for Completion

Under this arrangement, the sponsor provides an escrow account of sufficient funds to complete the project. An escrow account is, in effect, a trust fund established and funded by the sponsors. Funds are paid out from the escrow account for some specific purpose on the occurrence of some event. In the case of an escrow account to provide funds for completion, funds would be paid out to contractors to cover certified cost over-runs. Any excess not used could be returned to the sponsor upon completion.

Adequate ROE, ROI and ROA

Lenders must see that a project has a satisfactory economic incentive as measured by project ROE (return on equity) , ROI (return in investment) and ROA (return on assets) for the sponsor investors. There is indeed no better incentive to have continued commitment of the sponsors and investors than the potential to receive an excellent return on their investment.

Realistic Interest Rates Projection

The feasibility study and projections must include projections of interest rates will be available to the project throughout construction and operation. This is an area where the financial advisor and or lenders to the project can provide expert help. Since in long gestation projects a substantial part of the capitalized cost of a project will consist of interest expense, it is important that realistic increase assumptions be used for financial planning in the feasibility studies.

You must have thus noted that financing infrastructure project export is quite complex process. The key to successful infrastructure project export financing is identification of divers risk and their proper mitigation.

17.9 INTERNATIONAL BIDDING AND ENGINEERING-PROCUREMENT-CONSTRUCTION (EPC) CONTRACTING-FINANCING INSTRUMENTS AND ARRANGEMENTS

In order to deal with diverse risk in project export a number of financing instruments and arrangements have been developed. Let us briefly review them below.

Bid Bond

It is a bond guarantee provided by the Bank to the buyer providing compensation, usually on demand, in the event that a supplier declines to enter into a contract in conformity with the bid that has been put forward. Bid bond is issued for a maximum period of six months. Issuing Bank refunds 75% commission in case contract is not awarded.

Advance payment guarantee (APG)

It is a bond given by the bank to the overseas buyer on the amount of the advance payment and which will remain valid until progress on the contract equates to the amount of advance payment. Exporters are expected to secure a mobilization advance of at least 10% of the contract value.

Performance Gurantee (PG)

It is a bond provided by a bank to the buyer providing compensation in the event that the contract is not completed or goods supplied do not perform within the agreed specifications. It generally covers 5 to 10% of the contract value. Format of guarantee is required to be furnished by the exporter at least 4 weeks before actual issue to facilitate discussions / approval.

Guarantee for release of retention money (RMG)

This guarantee enables the exporter to obtain the release of full payments before obtaining Final Acceptance Certificate (FAC) from the client.

Guarantee for Overseas Borrowings

Up to 10% of the contract value bridging finance may be raised in foreign currency from a foreign bank against this guarantee. Request for overseas borrowings must be supported by currency-wise cash flows indicating also the outstanding letters of credit and L/C withdrawal schedule.

Guarantee commission is charged at the rates stipulated by FEDAI. Margin requirements for issue of guarantee is generally waived by Bank for Export Performance Guarantee. Appropriate securities (like ECGC cover/ GOI guarantee and counter guarantee) are, however, availed of.

Risk Coverage

ECGC provides cover in the form of specific policies covering non-receipt of payment due to political and commercial reasons. Various policies are :

a) specific shipment (comprehensive risks) policy

b) specific shipment (political risks) policy

c) specific contracts (comprehensive risks) policy

d) specific contracts (political risks) policy

ECGC also covers risks of banks by providing various types of guarantees depending upon the type of risk assumed by them in the form of various guarantees. Exporter can obtain cover to project himself against losses due to exchange rate fluctuations .

Other facilities

(Available to exporters subject to specific approval of RBI-ECD)

a) Foreign exchange remittance to meet initial expenses

b) Inter-project transfer of funds

c) Purchase of third country equipment

d) Opening of overseas bank accounts / camps at site / liaison officer, payment of agency commission etc.

Procedures

Exporter of engineering goods on deferred credit or turnkey projects is required to submit his application on the prescribed form the sponsoring bank. In the case of turnkey projects, implementation schedule, cash flow statements and a write up with regard to site, infra-structural conditions and sub-contracting arrangement should also be submitted alongwith the application form.

In case the buyer, is a party other than the Government, a status report on the buyer would first need to be obtained.

Bank can approve bids valued upto Rs. 2 crores and Export-Import Bank can approve bids valued up to Rs. 5 crore provided the bids confirm to the basic stipulations. Proposals to EXIM Bank can be submitted only through the bidder's bank.

All proposals where bid value exceeds Rs. 5 crores and also those proposals which do not satisfy and laid down basic condition, will have to be submitted to each member of the Working Group. Following agencies constitute the Working Group :

EXIM Bank, Bombay
RBI, Exchange Control Department, Bombay (ECD)
RBI, Industrial and Export Credit Deptt., Bombay (IECD)
ECGC Bombay
Participating Bank (s)

If the bid value exceeds Rs. 10 crores, copies are also to be forwarded to Ministry of Finance, Deptt. of Banking New Delhi ; Ministry of Finance, Deptt. of Economic Affairs, New Delhi; Ministry of Commerce, New Delhi. Project Exporters are required to call for a discussion at EXIM Bank / Bank after submission of the proposal. Within a week thereafter a meeting of the Working Group in convened at EXIM Bank in which EXIM Bank and other members of Working Group are represented. Clearance in principle is given at the meeting and bid bond can be issued immediately thereafter. This clearance of Working Group is valid for a period of six months.

Any changes in the pricing and terms and conditions of the offer, should not be effected without prior consent of EXIM Bank/ Working Group.

After Bid

Exporters are expected to keep EXIM Bank / bank informed of the bid results and progress of negotiations. In the event of bid not being awarded relevant information regarding the successful bid may be advised.

In case the contract is awarded, the exporter may approach his Bank, ECGC, RBI-ECD for formal approval of necessary facilities. He should also supply a copy of the contract / relevant excerpts and also the quarterly budgeted plants in terms of shipments, quantities of work, billing etc.

Check Your Progress B

1 What do you understand by the term BOT and BOOT?

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2 What are the main industries which are currently in demand for project export finance?

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3 What are the distinctive factors to be examined before preparing a viable project export finance proposal?

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4 What is a bid bond?

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17.10 LET US SUM UP

Project export finance differs from export finance and project finance. The export finance is cash export financing i.e. where payments are to be made within 180 days and the project finance is financing long term capital expenditure. Project export finance is financing Indian exporters who intend to execute project or undertake service contract or supply of goods. Project export has financial as well non-financial benefits. But there are commercial risk, country risk and exchange and interest rate risk in its execution. Project Export Manual issued by RBI contains regulatory provisions relating to Project/ Service export. The possible sources for loans or equity are either commercial lenders or sponsors. Host governments sometimes provide direct and indirect assistance. BOT and BOOT are new techniques used in project development. The financial success of infrastructure project financing depends upon many factors such as transport costs, adequate communication, availability of materials, reliable contractor/operator, managerial personnel, technology, expropriation risk and so on. In project financing banks provide various guarantees like bond, performance, advance payment; overseas borrowings etc. ECGC also provides cover in the form of specific policies.

17.11 KEY WORDS

ESCROW Account : A trust fund established and funded by the sponsorers

ODA : Official Developing Agencies like World Bank, Asian Development Bank, etc.

PEM : It is Project Export Manual issued by RBI.

Advance Payment Guarantee (APG) : It is a bond given by bank to the overseas buyer on the amount of advance payment and is valid till the progress on contract equates to the amount of payment.

Performance Guarantee (PG) : It provides compensation in the event the contract is not completed within agreed specifications.

RMG : Guarantee for enabling the exporter to obtain release of full payment before obtaining final acceptance certificate.

WG : Working group - is a body consisting of EXIM Bank of India, Reserve Bank of India Exchange Control and Export Credit Guarantee Corporation Member Participating Bank.

ER or IECD : Exchange Control and Industrial and Export Credit Department of the Reserve Bank of India.

ECGC : Export Credit Guarantee Corporation of India, Bombay.

AD's : The authorised dealers in foreign exchange.

EPC : Engineering-Procurement-Construction.

BOT : Build Operate Transfer.

BOOT : Build-Own-Operate-Transfer.

17.12 TERMINAL QUESTIONS

1 What is the importance of project export to our country?

2 Describe the regulatory frame work of project export financing in India.

3 What are the main sources of project export finance.

4 What are the different types of risks which a entrepreneur has to reckon while entering the area of project exports?

5 What is the Working Group Mechanism and who are its members and what are their financial powers.

6 How do sponsers / lenders safeguard against various types of risks in a project export?

SOME USEFUL BOOKS

Shapiro, Alan C., *'Multinational Financial management'*, Prentice Hall of India Pvt. Ltd. New Delhi.

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Erruna, Vihang R, Singh Devi and Srinivasan T.S. *'International Business Finance'*, Global Business Press, New Delhi.

Levi D. Maurice, 'International Finance', McGraw-Hill, New Delhi.