TERM LOAN FINANCING

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Term Loan

A Term Loan is an advance which is granted usually against the security of the borrower's Fixed Assets for a fixed term of not less than 3 years, is intended normally for financing acquisition of Fixed Assets, with a repayment schedule normally not exceeding 8 years.

Purpose of Term Loan

- Acquisition of Fixed Assets such as Land, Building, Plant & Machinery
- Modernisation / renovation /expansion / diversification of an existing unit
- Strengthening NWC
- Other Long Term Requirements - VRS

Purpose of Term Loan (Contd.)

- Purchase of second hand machinery
- Acquisition of balancing equipments
- Replacement of high cost debt
  (For residual period only)

Term Loans Vs Working Capital

- Purpose of TL is for acquisition of FA.
- Advance is not repayable on demand, but in instalments ranging over a period of years.
- Repayment is not out of the sale proceeds of the goods, but out of the future earnings of the unit.
- Security (FA) not readily saleable.

Appraisal of Term Loans

- The purpose of Term Loan appraisal is to ascertain whether the project is sound – technically, economically, financially and managerially and is ultimately viable as a commercial proposition.

Appraisal of Term Loans

- Appraisal of a project involves the examination of:
  1. Prima facie acceptability
  2. Technical Feasibility
  3. Economic Viability
  4. Financial Feasibility
  5. Commercial Viability
  6. Managerial Competency
  7. Other parameters
  8. Miscellaneous Issues

1. Prima facie acceptability

- Bank's lending policy / RBI Guidelines
- Prudential Exposure norms
- Substantial Exposure norms
- Individual & Group Exposure norms
- Industry Exposure norms
- Credit Risk Rating norms
- RBI Defaulter's List
- ECGC Specific Approval List

1. Prima facie acceptability (Contd.)

- Takeover norms, if applicable
- Government regulations
- MA in respect of cos., to know the scope of activity and borrowing powers
- AA in respect of cos., to know authorised signatories; no prejudicial clauses
- Project cost
- Proposed Debt / Equity
- CoProdn., Profitability, etc.

2. Technical Feasibility

- To determine the suitability of the technology selected and the adequacy of the technical investigation and design.

2. Technical Feasibility (Contd.)

- It consists of an assessment of the various requirements of the actual production process.

- It is in short a study of the availability, cost, quality and accessibility of all the factors required for production.

2. Technical Feasibility (Contd.)

Factors to be considered are:

- Location of plant & accessibility to critical inputs
- Size of the plant
- Type of technology
- Manufacturing process
- Labour
- Technical report

3. Economic Viability

- To determine the conduciveness of economic parameters to setting up the project and their impact on the scale of operations.

3. Economic Viability (Contd.)

This has reference to the earning capacity of the project. Since earnings depend on the volume of sales, it is necessary to determine how much output of the unit or additional production from an established unit the market is likely to absorb at given prices.

3. Economic Viability (Contd.)

Factors to be considered are:

- Thorough market analysis
- Future trends in volume and patterns of Supply & Demand
- Demand forecast, Supply position, Gap
- Intermediate product
- Ancillary industry
- Export oriented units

4. Financial Feasibility

- To determine the accuracy of cost estimates, suitability of the envisaged pattern of financing and general soundness of the capital structure.

4. Financial Feasibility (Contd.)

- This involves analysing the data received from the borrower to ensure that the project meets the following minimum financial criteria:

- Estimated project cost is reasonable and complete and has a fair chance of materialising as per anticipations.

4. Financial Feasibility (Contd.)

- Financial arrangement is complete, without any gaps, and ensures cash is available as and when needed.
- Estimates of earnings and operating costs are as realistic as possible.
- Borrower's repaying ability as judged from the project operation is demonstrable with a reasonable margin of safety.

4. Financial Feasibility (Contd.)

The basic data required would be:

- Cost of the project, including WCL.
- Means of finance.
- Cost of Production & estimates of profitability.
- Cash Flow estimates and sources of finance.

4. Financial Feasibility (Contd.)

Cost of the project includes:

- Land (Including site development)
- Building
- Plant & Machinery
- Other Fixed Assets / Misc. Assets
- Technical knowhow fees, etc.
- Power connection & installation charges
- Preliminary & Pre-operative expenses
- Contingencies
- Margin on WC requirements

4. Financial Feasibility (Contd.)

Means of finance includes:

- Equity Share Capital from promoters / other shareholders
- Preference Share Capital from Preference shareholders
- Debentures
- Unsecured Loans
- Deposits
- Loans from Friends & Relatives
- Term Loans from Banks & FIs
- Government subsidies
- Internal accruals

5. Commercial Viability

- To determine the extent of profitability of the project and its sufficiency in relation to the repayment obligations pertaining to term assistance.

5. Commercial Viability (Contd.)

- Cash Flow estimates help in determining the disbursal of the Term Loan.
- Estimate of profitability & BEP help in drawing up the repayment programme, start-up time, etc.
- Profitability estimate also helps in arriving at estimated DSCR, the single most important factor in Term Credit.

5. Commercial Viability (Contd.)

- A study of the projected Balance Sheet is essential to ensure that the unit will continue to have a sound financial position even after the implementation of the proposed project.

- BEP:

  In a mfg. unit, if at a particular level of production, the total mfg. cost equals the sales revenue, this point of 'No Profit-No Loss' is known as BEP.

5. Commercial Viability (Contd.)

- Mathematically, BEP =

$$\frac{\text{Fixed Cost}}{\text{Unit Sale Price - Unit Variable Price}}$$

- BEP is expressed as a percentage of sales / capacity.
- A good project should have BEP not higher than 70%.

5. Commercial Viability (Contd.)

- DSCR:

  Serves as a guide to determining the period of repayment of a loan.

- This is calculated by dividing cash accruals in a year by amount of annual obligations towards repayment.

- Gross DSCR =

$$\frac{\text{Cash Accruals + Interest on Term Loan}}{\text{Maturing annual obligations + Interest on Term Loan}}$$

5. Commercial Viability (Contd.)

- SMCR =

$$\frac{\text{WDV of Fixed Assets - Term Loan outstandings}}{\text{WDV of Fixed Assets}}$$

- Security Margin Cover Ratio is computed to verify that the minimum margin stipulated is maintained.

5. Commercial Viability (Contd.)

- The contribution of promoters to the project cost is to be ascertained.
- Margins to be arrived at.
- Debt Equity Ratio is to be calculated.
- Sensitivity Analysis:

  Is the capacity of the project to absorb various shocks, i.e., changes in critical factors like Cost, Volume & Price.

5. Commercial Viability (Contd.)

- Funds Flow Analysis to be done to ensure that:

✓ Internal cash accruals are sufficient to meet the requirement for the additions in the Fixed Assets during the period of the loan.

✓ Adequate long term surplus is available during the currency of the loan to meet margin for WC.

6. Managerial Competency

- To ascertain that competent men are behind the project to ensure its successful implementation and efficient management after commencement of commercial production.

6. Managerial Competency (Contd.)

- In a dynamic environment, the capacity of an enterprise to forge ahead of its competitors depends to a large extent, in the relative strength of its management.
- Integrity, track record, credit worthiness, initiative, competence and experience of the management should be examined.

7. Other parameters

- Examination of environmental regulations – To ascertain whether the project is in full compliance with the various environmental provisions in force.
- Examination of Government policies
- Examination of other statutory obligations

8. Miscellaneous Issues

- Return on Investment or the Rate of Return: This should not be less than what would have been earned in long term investment of funds in a bank.

8. Miscellaneous Issues (Contd.)

- Internal Rate of Return (IRR) : It is the rate at which the sum of the discounted cash flows is equal to the investment outlay. It gives an idea about the rate of return that a project is likely to earn over its useful life.

Thank You