Project management 101 *by Zavanak*

17. FINANCING & CONTRACTS

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17.1 Financing the project

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It’s all about the money

The source of funding for a project will generally have a big influence on the shape of the project itself.

We need to understand the source of funding’s motivation for being prepared to provide finance.

The design of the project may have to be modified to match their conditions and expectations.

There are lots of ways a project can be financed.

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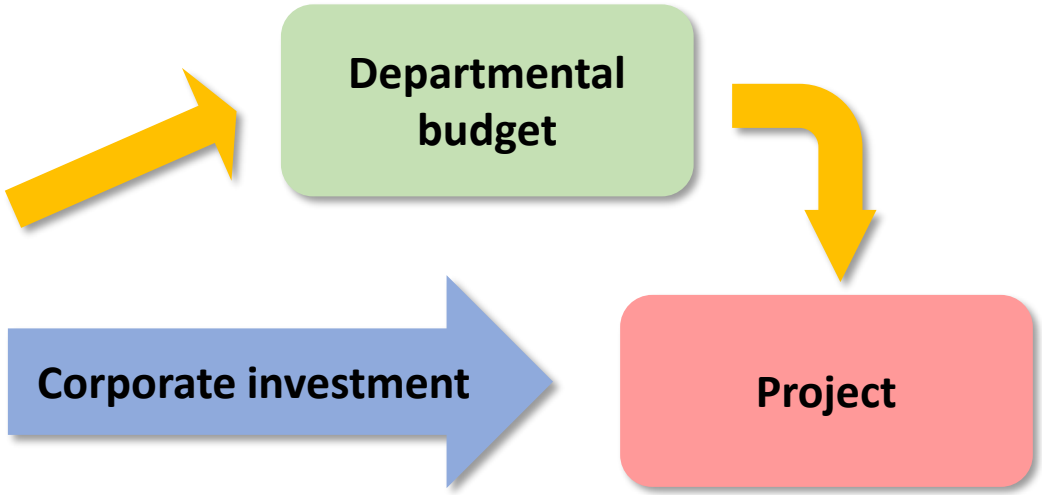
Corporate budget



The funding of the project is from the organisation's resources

Most small, internal projects are funded this way

The organisation bears all the financial risk of the project

Probably 99% of all projects get funded this way

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Borrowing

This is generally necessary for larger projects.

Lenders charge interest and fees.

The level of interest reflects their perception of risk of not getting paid.

They may require guarantees (e.g. a lien on the output so they own it until debt is paid).

If the project runs late or over-budget then additional borrowing may be needed at higher interest rates (due to the increased risk for the lender).

Borrowing is more expensive than internal financing.

The interest rate is often variable, so a rise in rates could jeopardise the business case for the project.

If the project is a failure, the organisation is carrying a lot of debt which the income from use of project output is not reducing fast enough.

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Project financing

This uses the project output (or what it produces) as bank security, rather than the assets of the contractor.

If say, the project is a chemical plant, then the contract can stipulate that the lender can buy its chemical products at a pre-determined price if the original loans cannot not be repaid.

Or the lender could require a guaranteed share of future revenues.

This approach is complex to set up and administer, especially if the lender is in one legal jurisdiction and the client is in another.

The deal may need to be underwritten by the central bank of the country where the project is to be carried out.

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Bonds

Bonds are an option for projects which should have a predictable income stream.

Bonds are issued by the project client through a financial institution.

The interest rate is fixed and a bond will be repaid with interest at a specified time in the future.

Bonds are attractive to organisations wanting low to moderate investment risks, like pension funds.

The bond issuer must repay the bonds or default on them, so bears the ultimate risk on the project.

Social Impact Bonds are a novel variant in which investors get a return only if certain social objectives in the project are met (like in a project to reduce rough sleepers by a certain number in a city)

This is a form of impact investing – aiming for social as well as financial benefits

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Venture capital

A venture capitalist puts money into a start-up in the hope of making a huge profit when they sell their stake after the business becomes a major success.

A VC takes a substantial equity stake and is frequently part of the management team.

VCs are often experienced entrepreneurs in the fields they invest in – such as Silicon Valley start-ups.

Because of the risk, VCs expect a very high standard of pitch – firm grasp of potential market, sound technology, management discipline and business savvy.

In some cases entirely new companies are formed around a project. Project funding is - in effect - equity funding. The founders seek a VC partner to fund the enterprise in return for a significant equity stake. The founders will generally have to put in personal security (e.g. their homes) to attract such funding.

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Targeted funds

Financial institutions such as life assurers and pension funds seek less volatile and uncertain investments than stock markets.

They put together funds to support very large projects (like rail and toll-bridge infrastructure) which have long-term revenue streams and growth in value.

This provides an alternative to government borrowing for projects like schools, hospitals and roads.

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Angels

Theatrical productions are often wholly or partly funded by investors prepared to take a big financial risk.

The pay-off is very high returns if the show is a hit.

A show may have dozens of angels.

A similar logic applies to many film and television productions.

Angels can also support business start-ups, such as spin-offs from university research.

It is not uncommon for friends and relatives to be investors.

Good angels will be active coaches and mentors.

The initial funding requirement is too small to interest bigger lenders, but if the start-up is successful they will move in and sideline the angels.

New arrangements will favour the new lenders' financial and management aims.

The failure rate of angel-funded enterprises exceeds 50%.

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Crowdfunding

This is often used to launch start-ups or community projects, especially when other funding routes have been fruitless.

The project promoter sets up a crowdfunding pitch on a web platform, with a target figure of cash to raise.

Individuals pledge amounts towards the target.

Incentives might include sneak previews, or preferential prices – graded for levels of donation.

If the target is not reached offer collapses.

If the target is reached or over-subscribed, the promoter has to use funds in the way they promised in the offer. Over-subscription can be ten-times target, or even more.

The start-up team will not get the experience and advice that other sources (like VCs) can provide.

The team may misjudge extra costs involved in crowdfunding as well as struggling to fulfil incentives.

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Share offering

A publicly quoted firm may raise project funds by issuing new shares.

In the short term a share offering will probably depress the share price, but the argument is that the new investment will drive up earnings per share when project output is in use.

If the share offering is not fully subscribed then the firm may have to use debt (borrowing) to plug the gap.

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Grants

A grant is a sum of money given to finance a project, generally subject to strict conditions.

Government grants are offered for specific types of project where organisations usually have to bid to receive support. They tend to be for areas like advanced research and development.

Lottery grants have similar conditions to government grants. They tend to be for activities like culture and health.

Often the grant provider expects its contribution to be matched with funds from other sources.

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Charity and philanthropy

Charities run or finance projects which aim for outcomes which are in line with the charity's purpose and objectives.

Projects are often in areas like alleviating poverty and suffering, conducting medical research, and providing care.

Philanthropy is giving by wealthy individuals (sometimes operating in a group).

Some funds distribute billions of dollars a year.

Targets for projects include cultural enterprises (like building art galleries), eliminating endemic diseases (like malaria) and supporting very ambitious work in fields like biochemistry.

Charities and philanthropy offer little if any support for purely commercial projects except as part of an economic development programme.

Be aware of philanthropists' motives – not all are pure.

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Public spending

The government funds projects which are determined to be of national importance.

The funds come from taxation and government borrowing.

The business case is often political as much as economic.

So it is susceptible to political interference.

The approval process tends to be protracted.

Public sector projects can suffer from delays, frequent re-scoping, and sudden cancellation.

Compared with other funding sources, a bigger share of projects funded this way are megaprojects.

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Foreign aid

This is provided by foreign governments (or multi-nation agencies like the World Bank) to improve economic and social conditions, especially for poorer citizens.

Conditions often include using suppliers from the donor nations and having liberal economic policies.

Involvement in multiple projects by multiple donors can make coordination difficult for recipient agencies.

Foreign aid projects often tend to impose 'best-practice' solutions rather than properly understanding local situations.

They are susceptible to corruption by officials and politicians.

They are an important tool of soft power diplomacy.

Foreign aid helped eradicate smallpox in the 1970s

It kick-started the South Korean economy in the 1950s

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Sovereign investment

Here, a government invests in (lends money to) a major project required by another government.

The basis of the deal is often strategic to the lender.

A large proportion of the project work likely to be done or managed by suppliers from the lender nation.

Effective interest rate may be very high.

The lender may retain a big equity stake or effective control of the output after project completion.

The recipient nation may be lumbered with long-term debt burden.

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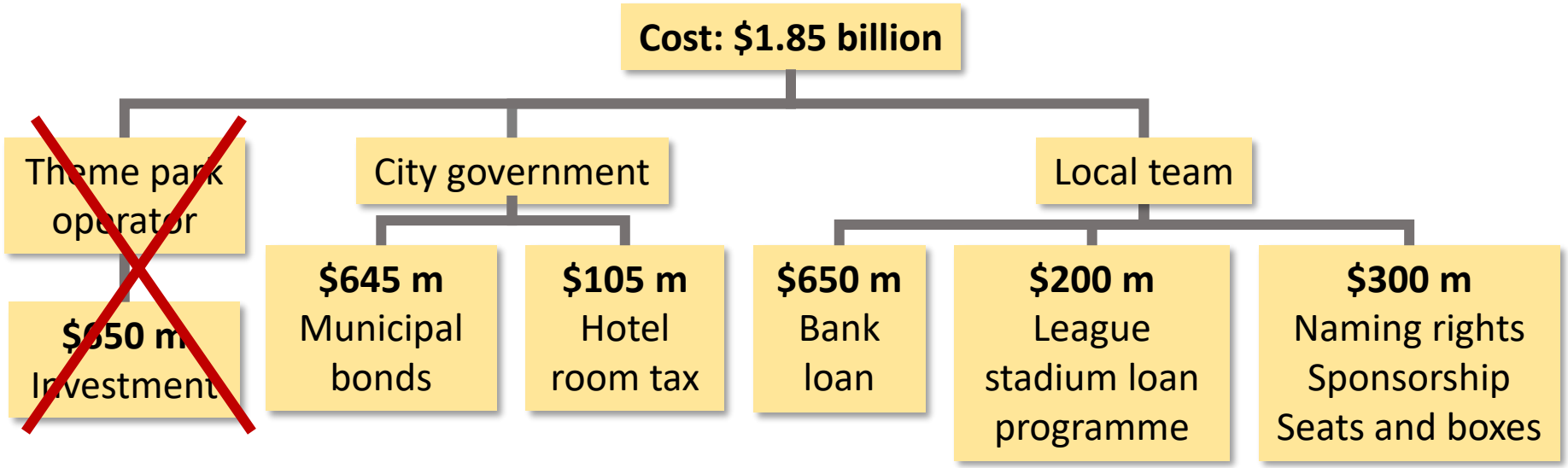
Complex financing: sports stadium



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