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TOOLKIT

Essentials of Corporate Finance and Obtaining Finance

Seminar for Management

Final Version

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Seminar Agenda

Agenda and Seminar Objectives

Session 1:	Introduction
Session 2:	Principles and assumptions of International Accounting Standards
Session 3:	Differences between Russian and International Accounting Standards
Session 4:	Options for moving to International Accounting Standards
Session 5:	Balance Sheet
Session 6:	Income Statement
Session 7:	Cash Flow Statement
Session 8:	Special issues in moving to International Accounting Standards
Session 9:	Implementation approach
Session 10:	Review of theory and homework discussion
Session 11:	Discussions with presenter and closure

ias1e/Page 1

INSTRUCTOR'S NOTES

This seminar is structured over 2 1/2 days. On day 1 we will introduce International Accounting Standards (IAS), the differences between IAS and Russian Accounting Standards (RSA).

We will briefly discuss the available options for moving to International accounting Standards.

On Day 2 we will cover the technical aspects of moving to IAS - specifically issues related to the balance sheet, income statement and cash flow. We will talk in detail about implementation.

At the end of day 2 participants will be given an assignment to be completed at their organization, which will help them get a practical understanding of the issues in moving to IAS.

We will return after about a week to summarize the presentation and answer any questions that the participants may have.

Seminar Agenda

Session 1: Finance Overview

Session 2: Project Selection

Session 3: Sources of Short-Term Finance

Session 4: Sources of Long-Term Finance

Session 5: Preparation, Approach, Negotiations

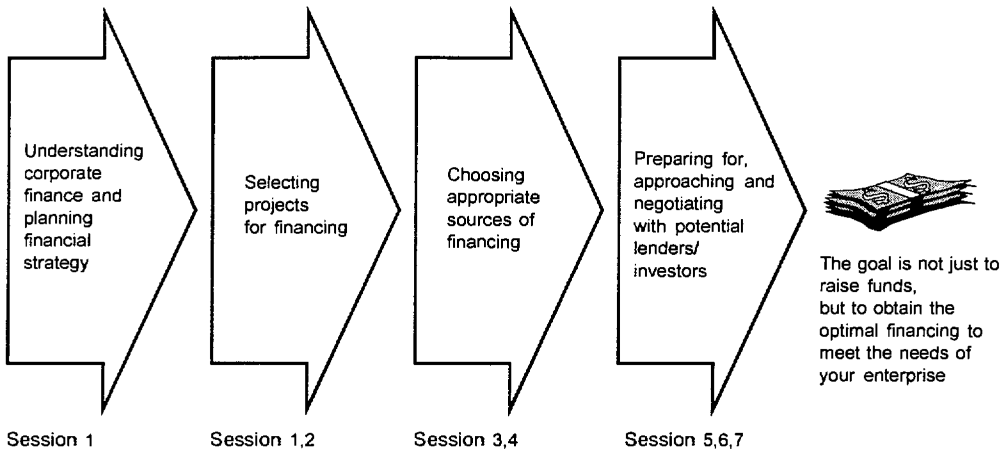
Session 6: Specifics of a Business Plan, Investment Memorandum, and Issue Prospectus

Session 7: Company Valuation

Session 8: Summary

Seminar Objectives - How This Seminar Can Help

The many options for short term and long term financing for Russian enterprises can be overwhelming. The processes for obtaining finance from different sources are varied and can be complicated. We will cover:



ofcf1e/Page 2

[This is a conceptual overview of what will be covered in the seminar]

<u>Discussion</u>:

Ask the participants:

What sort of a company needs financing? When do they need financing?

[The next two slides presents an example of when a company might need financing]

Seminar Format

The seminar will encourage your full participation in discussion sessions ...

... and will include class exercises and homework assignments to help you understand the material presented, practice using it and discuss the results with the presenter

ofcf1e/Page 3

Sladkoyeshka Chocolate Factory is in Trouble

Sladkoyeshka is profitable, has positive cash flow, satisfied employees, and satisfied (for the moment) shareholders. Russian consumers have always liked Sladkoyeshka chocolate, and still do.

Why is Sladkoyeshka in trouble?

Because the competition isn't standing still:

- Mars has built a $100 m factory in Stupino to produce Mars bars, Snickers, etc. Mars has also invested in a factory in Luzhniki, and has plans to construct more facilities.
- Nestle has invested $19 m in Rossiya Chocolate Factory in Samara. These funds are to be used for modernization of chocolate production facilities.
- Kraft Jacob Suchard has invested $25 m in a chocolate factory in Ukraine.
- Cadbury has set up an extensive distribution network for candy bars and other chocolate products in Russia. Cadbury is currently considering establishment of a production facility in Russia.
- The Red October chocolate factory in Moscow completed a public issue of shares raising $12 m to invest in reconstruction of existing equipment and purchase of new equipment for production of existing and new chocolate products.

ofcf1e/Page 4

<u>Example:</u>

Let's take a look at the situation of Sladkoyeshka Chocolate Factory, a mythical company. While Sladkoyeshka is not a real enterprise, the transactions listed are.

<u>Discussion - ask the audience:</u>

- What is the company's main problem?
- What is the solution?

<u>Background information on the Red October issue</u>

(in case there are questions)

The Red October share issue was done under an aid funded project (British Know How Fund) as a pilot case to demonstrate how Russian privatized enterprises could raise money through new share issues. The issue set new standards for disclosure of information, which was welcomed by foreign investment funds in Russia. Despite some negative press about the lack of individuals prepared to buy shares, the issue was successful, although extremely expensive - well beyond the means of most medium size Russian enterprises.

Sladkoyeshka Must Act Now

Sladkoyeshka is facing increasing competition from both Russian and foreign chocolate manufacturers. These competitors have ready access to financing to raise money to:

- Lower production costs
- Increase product range and quality
- Set up distribution systems
- Advertise their products extensively

Where does this leave Sladkoyeshka?

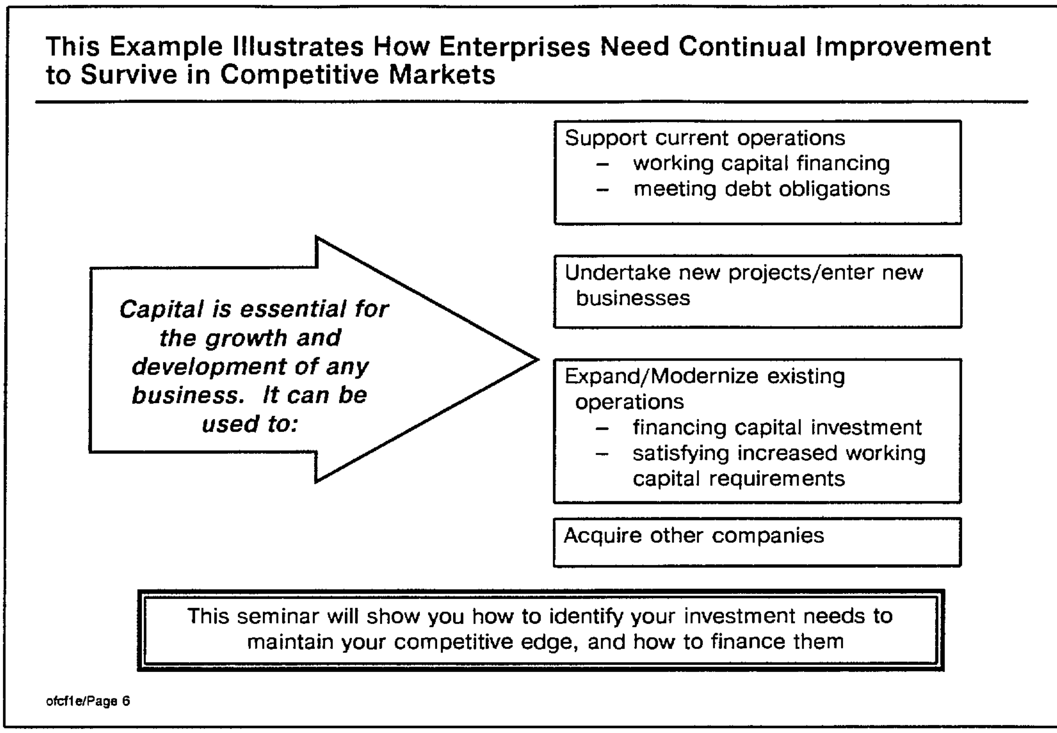
- The company must immediately define its competitive advantages over competitors, develop its strategy for beating the competition, and identify projects consistent with this strategy that deserve and require financing
- Once the company has a well-defined strategy and has determined which projects are appropriate, it must find financing
  - But what financing is required? Short-term? Long-term? Debt? Equity?
  - To whom should the company look? Banks? Investment funds? Strategic investors?

There is a war going on in the chocolate industry. How about in yours?

ofcf1e/Page 5

Discussion - ask the audience:

- Has anyone developed a project and tried to raise financing recently?
- How did they decide whether or not their project was worth financing?
- How did they start?
- How did they select the type of financing?
- How long did it take (if successful)?



Emphasize:

Financing is required to raise capital that the company can use to meet its objectives.

Operational needs

Example - Taking a bank loan to meet current obligations of taxes, salaries, and energy.

Current operations

Example - Using retained earnings to purchase new equipment.

Undertaking new projects or expanding into new businesses

Example - Selling 3 existing machines to purchase one new machine for a different type of production.

Emphasize:

Financing can come from **internal** sources as well as from external ones (banks, investors).

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ofcf1e/Page 7

Explain:

In this section we will cover:

- what corporate finance is
- the time value of money
- the importance of project selection
- planning financial strategy
- how to chose between short term and long term financing

Introduction to Corporate Finance

Key Concept:
Time Value of
Money

What is corporate finance?
- Strategy
- Projects
- Assets & Liabilities

Do I need Financing?
What kind?
- Short-term
- Long-term

How do I choose the right project?
Where do I get financing?

This section will introduce you to the principles of corporate finance, and the concepts that we will discuss in detail in the rest of the seminar

ofcf1e/Page 8

Financing Is Not Just About Obtaining Money

Corporate finance is closely related to a company's balance sheet - equity and short-term liabilities finance long and short-term assets

Financing has a cost - the cost of capital

The financial director must seek to maintain an optimal level of finance and minimize the cost of capital for the firm

AO Bicycle Company
Balance Sheet
as of 1/1/96

	1/1/95	1/1/96		1/1/95	1/1/96
Assets:			Liabilities:		
Long term assets	1803000	3095000	Equity	2584000	3605000
Intangibles	0	0			
Fixed assets	1803000	3095000			
Short term assets	3048000	10370000	Bank loans	2267000	9860000
Inventories	1323000	4275000			
Receivables	1528000	5716000			
Cash	197000	379000			
Total Assets	4,851,000	13,465,000	Total Liabilities and equity	4,851,000	13,465,000

ofcf1e/Page 9

Ask the audience for definitions of finance.

<u>Emphasize</u>:

Make it clear that finance is not just money, and that it is not ***given*** to the company. Finance is a strategic asset linking the left and right hand sides of the balance sheet. As with any resource, finance has a **cost** which one should try to minimize.

<u>Emphasize:</u>

Every member of senior management needs to understand the role of the financial department, and the processes involved in raising financing.

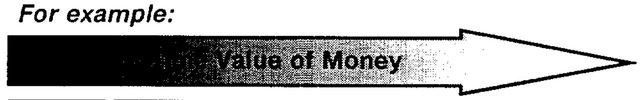
The "Time Value of Money" is a Key Concept to Understanding all Types of Financing

How much would you pay for the right to receive $100 one year from now?

If you answered "$100," you didn't think about the Time Value of Money!

The Time Value of Money refers to the different values that the same amount of money has now and in the future.

This difference in value is driven by a mix of factors, including inflation, risk, and opportunity cost. This means that money in the future is less valuable than it is today. For example:



Year:	1996	1997	1998	1999	2000	2001
Value of $100:	$100	$90	$83	$75	$68	$62

In this example, you would pay no more than $62 for the right to receive $100 five years from now

ofcf1e/Page 10

This slide introduces the concept of time value of money. Make sure the audience is familiar with the concept.

<u>Explain</u>

A dollar held today is worth more than the same dollar held in the future. This is due to three reasons: inflation (very noticeable in Russia), risk, and opportunity cost. The opportunity cost is an amount of money, in addition to the effects of inflation, that could be made by investing the dollar, instead of holding it.

Survey the audience "How much would you pay for the right to receive $1000 in a year?" and "How much would you pay for the right to receive 500 million rubles in 1 year?" Write down the results and average them. Compare them.

The importance of these questions is that it gets across the point that ruble discount rates and dollar discount rates are different because they contain different risks.

Financing Includes Creating a Short and Long-Term Financial Strategy for the Company

What are your current financing needs?

How will they change six months from now?

How will they change one year from now?

What will they be 3-5 years from now?

What will you have to do now to prepare for future investment?

What will be the right mix of long term financing for your company - what percentage debt, what percentage equity?

How will your shareholding structure change?

There are two basic types of finance available to meet your needs:
Long-term and short-term finance
Let's take a look at each in more detail

ofcf1e/Page 11

Explain:

- It takes several months to get short term debt financing
- It takes half a year minimum to get long term debt financing or financing from portfolio investors
- It takes longer to get a strategic investor or to do a public share issue

These will be discussed in more detail later in the seminar.

Short-Term Financing is Often Used to Fund Working Capital

Working capital is needed to survive and continue operations in the short-term

Net working capital = current assets - current liabilities

- Working capital is needed for:
  - Purchase of raw materials
  - Investment in work in progress
  - Investment in finished goods
  - Investment in the net of accounts receivable minus accounts payable
- Working capital requirements:
  - Differ across industries and companies
  - Have seasonal and/or cyclical fluctuations
  - Depend on efficiency of product portfolio management
  - Depend on working capital management policies
- Working capital requirements are normally met through one of two short-term financing measures:
  - Internal financing
  - Short term credit

ofcf1e/Page 12

Explain:

Net working capital is defined as current assets less current liabilities. In real terms it represents the resources that are available to maintain operations in the short-term.

Example:

Management decides that it should keep 3 weeks of a particular product in stock for immediate shipment upon request. The production of that material requires raw materials, labor, and energy. Since the goods will be in the warehouse, payment will not be received immediately. The company must pay the costs of production without receiving revenue from the production. This investment in finished goods is made possible by working capital.

Explain:

The amount of working capital required by an enterprise depends on the length of its production and sales cycles, its credit policies, seasonal sales variations, and efficiency of internal processes such as procurement, sales, production planning, and inventory control.

Working capital requirements can often be met through internal financing -- tighter credit policies, more effective collection of receivables, more rigorous inventory control. Of course, short-term bank loans are also available.

These sources of short-term finance will be discussed in more detail later in the seminar.

Short-Term Finance is Flexible, But Risky

- ⇨ Funds required and made available for a period of one year or less; in the case of Russian bank financing, six months or less
- ⇨ Unsecured, or secured by inventory and receivables
- ⇨ Flexibility - can be repaid before maturity if the funds are no longer needed
- ⇨ High Risk - rolling over or renewal is not guaranteed
- ⇨ Cost of rolling over or renewal may be high

ofcf1e/Page 13

Emphasize:

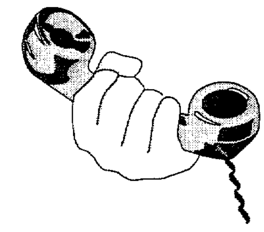
Short-term financing is usually required for less than a year.

Short-term financing is often available without supporting documentation demonstrating the intended use of the funds

Short-term financing can often be repaid before schedule if it is no longer needed, thus reducing financing costs.

The ability to extend the financing is not guaranteed; it may be necessary to return the financing at an unfavorable time.

Does Your Enterprise Actually Need External Short-Term Financing?



A company may be able to find financing "internally" through better management of working capital:

- Decreasing accounts receivable
  - Adjusting customer credit policies
  - Monitoring receivables on a daily basis
  - Making an effort to collect overdue receivables
- Negotiating longer credit with suppliers
- Lower level of inventories
  - Economical purchasing of raw materials
  - Stop manufacturing products for stock, produce only when you have customer orders for these products

...so external working capital financing may not be needed

ofcf1e/Page 14

Mention here that working capital management is a seminar itself, but here are a few ideas for freeing up cash by reducing working capital requirements.

<u>Emphasize</u>:

Bank loans are not the only form of short-term financing.

Many companies have untapped sources of internal financing. Freeing these resources will probably require modifications to existing functions and procedures.

Internal financing is less expensive than arranging for other financing. Searching for internal sources of financing should always come first. You should not curtail pursuing additional external financing when needed if you have additional projects which meet your strategy and financial criteria and cannot be financed by internally generated funds.

Long-Term Financing is Usually Used to Fund Capital Investment

Constant development is essential for a company to stay competitive. It requires substantial financial resources to:

- Develop/acquire new technologies
- Purchase modern equipment
- Develop new products or enhance existing products
- Build distribution networks
- Improve management information and reporting systems

Implementing any of these types of projects will require long-term financing

ofcf1e/Page 15

Emphasize:

Capital investment is necessary for your company's success and should be continuous under normal business conditions -- the returns of current projects can be channeled into new projects.

However, for companies in "survival" mode, cutting back on capital investment is an important source of short term finance. Once the company is back on its feet, it will want to resume capital investment for development of the business, and will need to plan how to finance this investment.

Long-Term Finance is Less Risky for the Enterprise, but Difficult to Obtain in Russia

- Funding for 1 year or more; in the case of Russian bank financing, six months or more
- Almost always secured by fixed assets and/or guarantees from shareholders
- Requires supporting information e.g. business plan, financial projections to prove ability to service and repay
- Inflexibility - may prove expensive as interest rates are declining, unless the terms can be renegotiated
- Generally higher cost than short term financing, because it is a more risky loan or investment for the bank/investor

ofcf1e/Page 16

Emphasize:

Long-term financing is required for projects with an investment cycle longer than 1 year. Russian banks consider loans with a payment period longer than 6 months to be long-term because of inflation and other uncertainties in the economic situation.

Long-term financing from external sources is nearly always secured (backed by something of value) ensuring that the financier will receive something if the borrower defaults on the terms of the financing.

People and organizations providing long-term financing will always require documentation about your intended use of the money in order to determine the likelihood that you will be able to repay the loan or that they will make an acceptable return from their investment. For all investors and financiers, their profits are determined by how you will use their money.

Does Your Enterprise Really Need External Long-Term Financing?

A company may generate long term financing internally through:

- Retained profits
- Sale or lease of idle or under-utilized assets
  - Equipment/machinery/buildings
  - Stocks of finished products and raw materials
- Sale of unprofitable business lines
- Sale of non-core businesses

...so external financing for capital investment may not be needed

ofcf1e/Page 17

Explain:

Long-term financing can come from internal sources (just like short-term financing). Internal sources of long-term financing are retained profits, the sale (or leasing) of fixed assets, and the divestiture of non-core activities.

Leasing assets provides a stream of income and allows the company to retain ownership of the asset.

In practice, the current market in Russia for selling fixed assets or business lines is severely limited. Many enterprises, however, have been successful in renting out unused buildings to small private companies for production or warehousing space.

Emphasize:

As with short-term financing, examine your internal sources of long-term financing before looking for external financing. Internal financing, if sufficient to meet the company's project financing needs, will always be cheaper than external financing.

Two Types of External Long-Term Financing Exist: Debt and Equity

For the enterprise, debt is more risky but equity is more costly

Debt Financing	*Equity Financing*
• Fixed charge source of finance, not dependent upon return on assets • Interest and principal legally required, unlike dividend • Timing can be structured to match inflows and outflows, but pre-determined • Cost of raising debt is comparatively low • Usually secured by fixed assets or guarantees	• No cash outflow liability for redemption • No legal obligation to pay dividends • Increases company's financial base and capacity for borrowing • Most expensive source of finance but company decides amount of dividend (may be less interest) and the cost of raising equity financing is high • Investors expect a higher return on their investment because risk is high • Expanding equity dilutes the ownership and control of existing shareholders

ofcf1e/Page 18

Emphasize:

Long-term external finance is divided into **debt** financing and **equity financing.**

Example:

Debt financing -- long-term bank loan

Equity financing -- offering of new shares of stock to investors

Each method has its advantages, disadvantages, and cost structures. The chosen method will depend on many variables.

Instructor's Notes:

Note also that dividends are not tax deductible which represents an added expense. On the other hand, the company determines the level of dividends to pay out.

Exercise: When Does an Enterprise Require Short or Long-Term Financing?

What type of financing is required for (circle one):

(A) purchase of raw materials	Short term	Long term
(B) delay in collecting accounts receivable	Short term	Long term
(C) purchase of new equipment	Short term	Long term
(D) slowdown in turnover of finished goods stock	Short term	Long term
(E) new product development	Short term	Long term
(F) acquisition of a business	Short term	Long term

ofcf1e/Page 19

Exercise:

Tell the audience to turn to this page in their slide pack and test themselves by circling the correct answer for each situation.

Emphasize

The type of financing is tied to the intended uses of the finance received. Also, both short-term and long-term financing can come from both internal and external sources.

Answers are given on the next slide.

Exercise: When Does an Enterprise Require Short or Long-Term Financing? (Solution)

The required type of financing is:

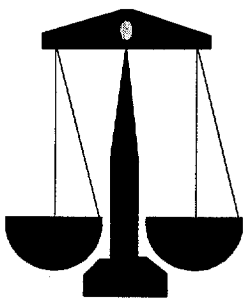
(A) purchase of raw materials	$\boxed{\text{Short term}}$	Long term
(B) delay in collecting accounts receivable	$\boxed{\text{Short term}}$	Long term
(C) purchase of new equipment	Short term	$\boxed{\text{Long term}}$
(D) slowdown in turnover of finished goods stock	$\boxed{\text{Short term}}$	Long term
(E) new product development	Short term	$\boxed{\text{Long term}}$
(F) acquisition of a business	Short term	$\boxed{\text{Long term}}$

ofcf1e/Page 20

Project Selection, Step One: Pick the Best "Strategic" Projects

Choosing the right project is critical - it requires both a strategic and financial evaluation

STEP ONE: **First, the firm must determine if the project, or projects it will be financing make strategic sense**



Key Questions to ask:

- How does the project fit into the overall **strategic plan** of the firm? Does it:
  - Increase efficiency / lower costs?
  - Enter new markets with existing products?
  - Enter existing markets with new products / product enhancements?
  - Enter new markets with new products?
- What are the firm's **alternatives** to the project?
- What impact will the project have on the firm's position relative to its **key competitors**?

ofcf1e/Page 21

Explain:

Your project must make strategic sense for your company - what does this mean?

- in western markets, it usually means staying within the business areas of expertise of the enterprise

- in Russia, there may also be opportunities for selling new products and services

BUT:

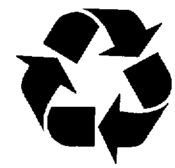
- you must make sure that you have the skills to exploit these opportunities

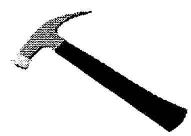
- any new projects outside your area of expertise will be much more difficult to get external financing for

Project Selection, Step Two: Ensure the Strategic Projects Make Financial Sense

After selecting the best "strategic project", the firm must determine if it makes financial sense to pursue them

- How will the project alter the **cash flows** of the company?
  - Lower operating costs?
  - Increased revenues?
  - Tax savings?
  - Lower cost of capital?





- Does the project meet or exceed the firm's internal financial benchmarks?

- What generates the project's value?

ofcf1e/Page 22

<u>Discussion:</u>

Ask if anyone has looked for financing already, ask them how his/her project changed the cash flows of the company. How did they determine if the project would be financially beneficial? How did it turn out?

The focus now should be on broadly recognizing if a project adds value or not. If it does, participants should understand what drives that value.

<u>Explain:</u>

Value can come from lower costs (resulting from improved use of assets or improved operational processes), lower taxes, increased sales.

Who will benefit from the project? (shareholders? investors? managers? employees? customers?)

Internal financial benchmarks for evaluating a project will be discussed in detail later in the seminar.

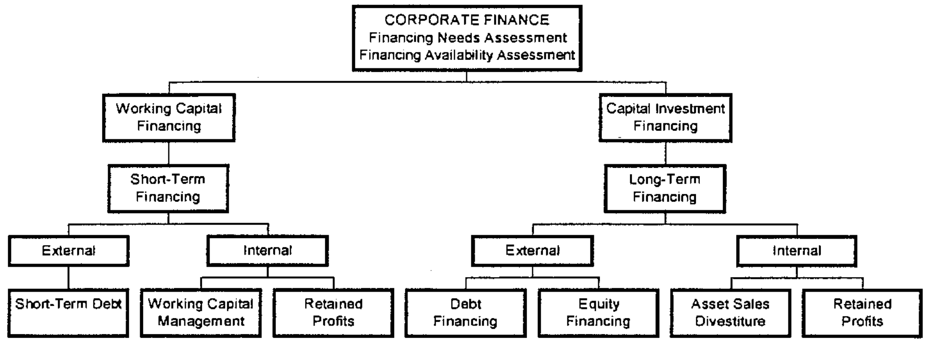
Once Management Has Picked the Right Project, Identify the Best Source of Financing

Intended use of financing	*Type*	*Potential sources*
Working Capital Bridge Financing	Short-term	Internal (working capital management) Trade credit Short-term leases Mutual settlement / offset Commercial paper / notes Bank finance Factoring Tolling
Capital investment • Expansion / modernization of existing businesses • Entering new businesses • Acquisitions	Long-term	Debt financing • Bank debt • Bond Issues Equity financing • Portfolio investors • Strategic investors Other types of financing • Bonds/ Convertible Bonds • Leasing

ofcf1e/Page 23

Where Do We Go From Here?

This chart shows the range of issues involved with corporate finance and obtaining finance



Now that you have a basic understanding of what corporate finance is, let's look at these topics in more detail

ofcf1e/Page 24

<u>Emphasize:</u>

In summary,

Once you've decided which projects to finance, you can decide whether you need short term or long term financing.

The next two sections of the seminar will discuss what the options are for each.

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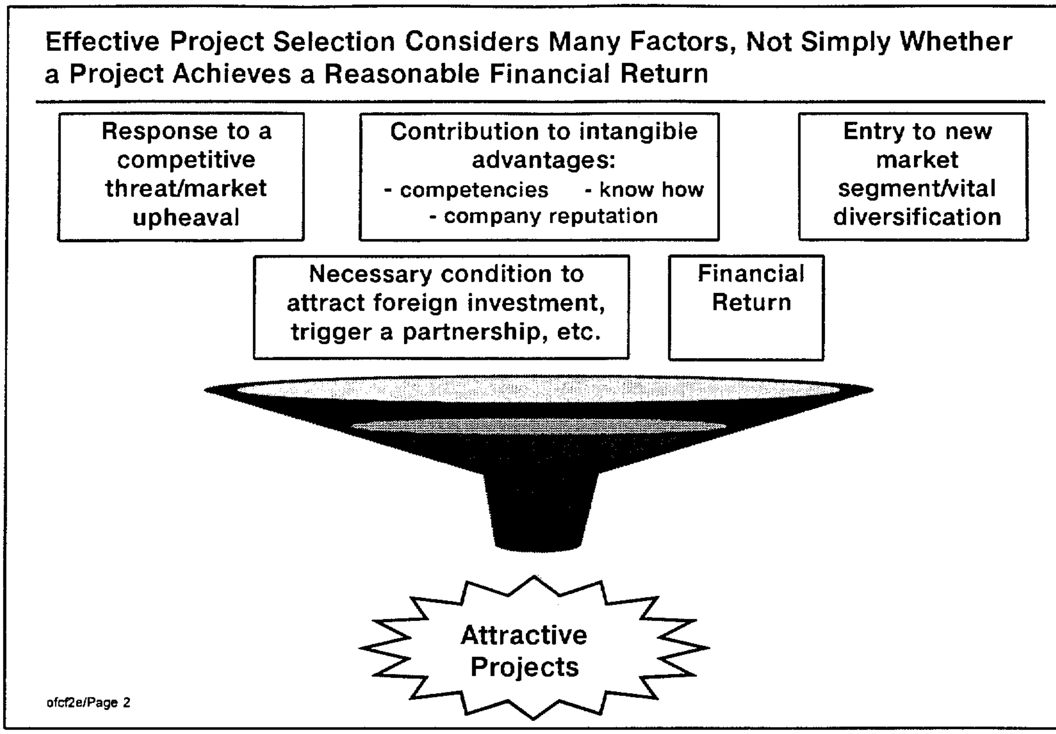
ofcf2e/Page 1

Projects should be selected on their merits as to how much value they add to the firm.

This section goes through the projects of internal project selection, both strategically and from a financial point of view.

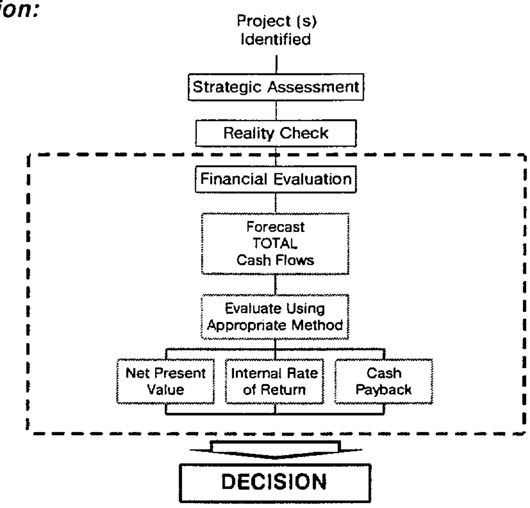
Financing then should be pursued only for projects which meet the firm's internal selection benchmarks.



There are some times when a company is forced to act - these types of situations are shown in the top 3 boxes.

Effective Project Selection Requires a System for Project Evaluation

The best system includes a strategic evaluation, a "reality check" and a financial evaluation:



This section of the seminar will take you through each step of this process!

ofcf2e/Page 3

We will first discuss strategic valuation, then we will go through cash flow forecasting, and finally, we will discuss net present value, internal rate of return and cash payback - 3 methods for financial evaluation.

First, Assess the Strategic Value of the Project to the Company

Does the value added by the project correspond to the company's strategic goals? Two key questions:

Does it contribute to any of the company's short or long-term strategies?

Does it fit into the core competencies of the company or exploit new opportunities?

<u>Short-term strategies</u> • Cash generation • Cost reduction • Production increase	<u>Long-term strategies</u> • Market repositioning • Market share target • Acquire new technologies • New market targets

<u>Core competencies</u>
• Modernize or add to the existing business in order to:
  • Lower costs
  • Increase efficiency
  • Expand production
	<u>New opportunities</u>
	• Take advantage of access to new technologies
	• Acquire a complementary business
	• Innovations of old product lines

ofcf2e/Page 4

Example 2.1: Strategic Fit

AOBC is an experienced Russian bicycle producer. It has two projects to choose from:

- Investing in a new technology that will reduce the costs of producing bicycles
- Investing in an equipment line that will allow it to use waste materials as inputs into cardboard boxes for fruit juice. The line would be placed in a currently un-used building

AOBC has recently experienced a financial crisis

- Profits have been low due to high costs
- Sales have been weak due to increased competition from low-priced imports

Management has identified the following strategies in response to the situation:

- Reduce costs to allow for higher margins and price-competitiveness
- Regain position as leader in the Russian bicycle market

On a purely strategic basis, which project should AOBC select?

ofcf2e/Page 5

Example 2.1 - Strategic Fit (cont.)

Let's look at the strategic fit of both projects:

- The bicycle project fits both the short and long-term strategies, taking advantage of one of the company's core competencies
- The fruit juice project does not contribute to strategy, and is not complementary to the core business

But, what if the fruit juice project offers a much higher financial return?

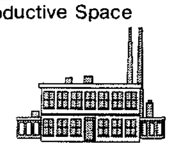
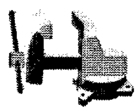
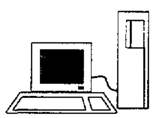
- Given the current financial situation of AOBC, it will be difficult for AOBC to find financing for *any* projects
- But, with AOBC's skills and experience in the bicycle industry, it will probably be able to obtain financing for sensible projects in that area
- Only later, after AOBC has demonstrated its ability to operate profitably in its core business, will financiers consider investing in AOBC's diversification plans

If you don't think a project makes a strategic fit with your company, no one else will either - regardless of the potential returns

ofcf2e/Page 6

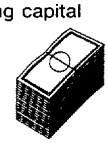
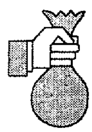
30

Second, a Reality Check - Is the Project Truly Necessary - Can Save Much Time and Effort

Project Category	*Specific Examples*	*Questions*
Productive Space 	• Capacity increase for constrained but profitable product line • Renovation of unused space to be put up for outside lease	• Do we really need the extra space? Can we not reorganize the space we already have? • Do we really think the new space will generate the forecasted revenues?
New machinery 	• New equipment to produce a new product demanded by current customers	• Could we do the same work with human labor instead of extra machinery? • Have we estimated the full cost of the machinery, including spares, maintenance and down-time?
Facilities Modernization 	• Installing a new management information system	• Could we do these tasks manually?

ofcf2e/Page 7

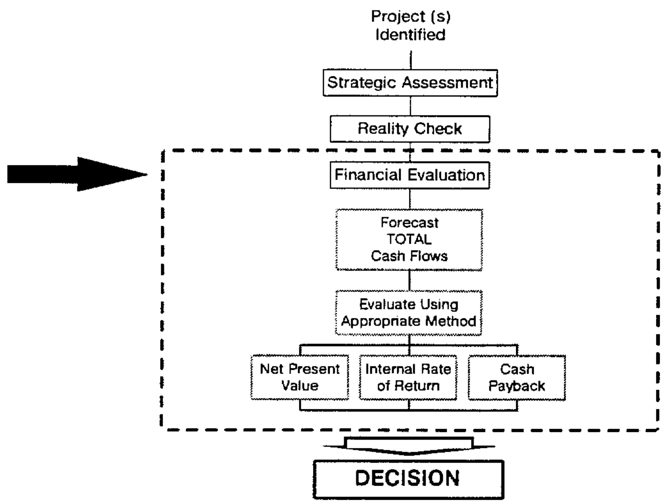
Reality Check (cont.)

Project Category	*Specific Examples*	*Questions*
Working capital 	• Financing to hold the company over for 2-4 weeks until an expected payment comes in	• Are we sure this is an extraordinary expense? Will it fix a problem or just treat the symptom? Will we need to raise the same money again next month?
Debt repayment 	• Taking on lower-cost debt to replace high-cost debt in order to lower future interest expenses	• Why are we unable to pay our debt back? Is this a quick fix, without solving the fundamental problem?
New business lines 	• Developing a new product line • Diversification away from declining businesses • Rounding out a full product line in response to consumer demand	• Do we have the skills to make this new project work? • What is our competitive advantage in this line of business? • Can we afford to be distracted from our main business?

ofcf2e/Page 8

Effective Project Selection Requires a System for Project Evaluation

Now we are ready to move on to the financial evaluation:



ofcf2e/Page 9

We will first discuss strategic valuation, then we will go through cash flow forecasting, and finally, we will discuss net present value, internal rate of return and cash payback - 3 methods for financial evaluation.

Project Financial Evaluations are Based on *Incremental* Cash Flow Forecasting

Incremental cash flows are changes in the firm's net cash flow occurring as a direct consequence of accepting a project

Using incremental cash flows allows you to:

- Account for all cash inflows and outflows associated with the project
- Consider increased working capital requirements
- Ignore sunk costs, which are irrelevant to the project
- Account for opportunity cost (e.g. land that will be required for building a workshop may have alternative uses)
- Estimate overheads on an incremental basis, i.e. cost of increasing staff - not allocation of existing staff to the project

ofcf2e/Page 10

The following slides show how to forecast/estimate cash flows for a project.

What Generates a Good Cash Flow Forecast?

The value of a cash flow forecast depends on how successfully it answers the following questions:

- What is the size of each flow?
- What will be the exact timing of each flow?
- What is the opportunity cost of investing in the right to receive the future flows?
- What is the risk/probability of receiving flows?

Several scenarios should always be tested:

- Best case
- Worst case
- Most likely case

Good cash flow forecasts are always:
- Realistic
- Detailed
- Backed up by well-thought out assumptions

ofcf2e/Page 11

Explain:

Cash flow forecasting is always very difficult, especially in Russia. This makes running different scenarios particularly important.

10

35

The First Step in Preparing a Cash Flow Forecast is Choosing the Currency

In an economic environment with high uncertainty and high inflation rates, the choice of currency is very important to successful cash flow forecasting

Here are some key factors to consider:

It may be wiser to use USD (or some other hard currency) if:

- looking for an international investor
- a significant part of initial investment / operating costs are expressed in hard currency
- inflation is high

It may be wiser to use RUR if:

- the company is not significantly exposed to international markets
  - raw materials are sourced in Russia
  - products are sold in Russia
- the likely source of financing is Russian

Forecasting in hard currency also makes estimating the discount rate easier - a concept we will discuss when looking at evaluating cash flow forecasts

ofcf2e/Page 12

Example: AOBC Has an Investment Project - How Will the Project Impact AOBC's Cash Flow?

AOBC is an experienced producer of sports bicycles, who has faced a number of recent challenges:

- Increased competition from Chinese imports and general economic recession have depressed sales
- Increased raw material prices have reduced profitability

In response to the situation, AOBC is considering an investment in new equipment and licensing technology. Management believes the project will improve product quality, and increase yields from raw materials

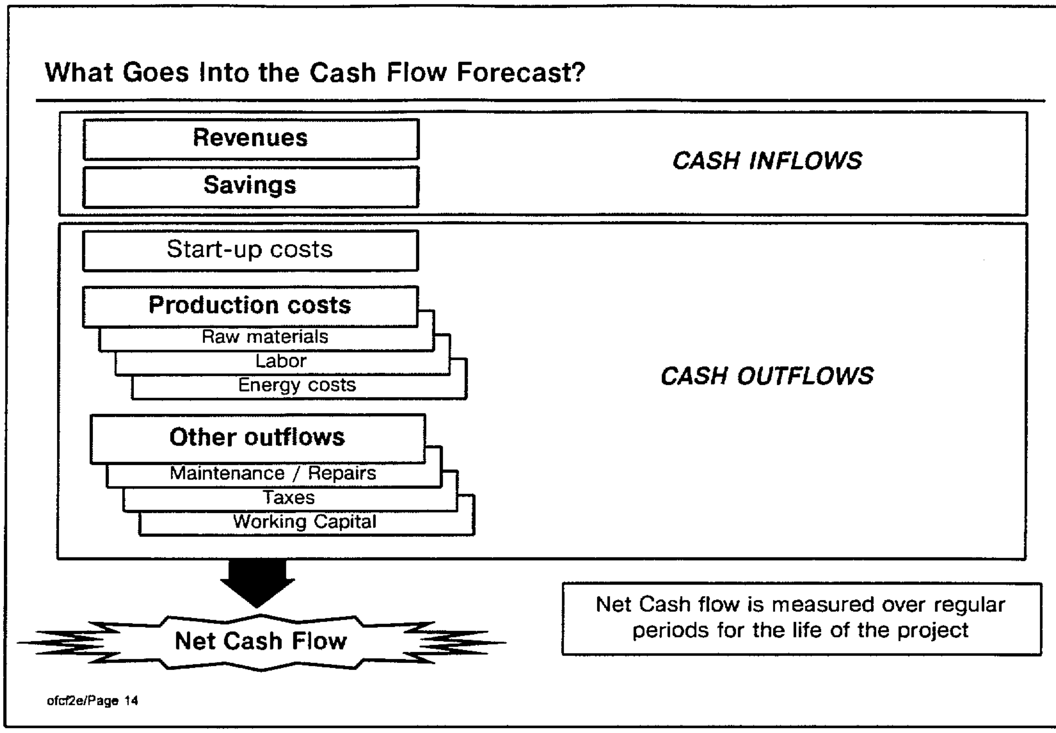
Producing higher-quality bikes should win back market share from the Chinese, and greater efficiency will increase profitability.

The company's Board of Directors is scheduled to meet in one week, and has agreed to consider the project at that meeting. The General Director must prepare a presentation for that meeting, including a thorough financial evaluation of the project. His next step is to estimate the project's cash flows

ofcf2e/Page 13

This is the introduction to a simplified example of cash flow forecasting, which will be presented in the following slides.

A real enterprise selecting projects for financing should have more detailed calculations of cash inflows and outflows.


What Goes Into the Cash Flow Forecast?
Revenues
Savings
CASH INFLOWS
Start-up costs
Production costs
Raw materials
Labor
Energy costs
Other outflows
Maintenance / Repairs
Taxes
Working Capital
CASH OUTFLOWS
Net Cash Flow
Net Cash flow is measured over regular periods for the life of the project
ofcf2e/Page 14

First, the General Director Calculates the Project's Start-up Costs, Which are Called Cash Outflows

The project's start-up costs are summarized in the following table:

(RU '000)	1996	1997	Total	Depreciable Basis
Building Renovation	50,000	0	50,000	n/a
Equipment	1,200,000	0	1,200,000	1,200,000
Installation costs	120,000	0	120,000	n/a
Technology licensing	100,000	400,000	500,000	n/a
Total outflows	1,470,000	400,000	1,870,000	

Notes:

- The incremental outflow related to the building is only the renovation costs. The building itself is a sunk cost, and therefore not relevant to the analysis of the project

This column identifies which incremental start-up costs will be depreciated over the course of the project. This will come into play in a later step

ofcf2e/Page 15

Step through how to prepare the following 8 slides:

•Forecast project startup costs and the time at which the costs will be incurred

•Do not forget any data that will affect your future cash flows (i.e. depreciation is not a cash expense, though it affects cash outflow, i.e. it is tax deductible and decreases tax payments)

Next, the General Director Projects Future Incremental Inflows and Outflows

Begin with a projection of sales volume - the basis of the cash inflow from gross sales. How?

Sales volume and price forecasts are based on available historical data and additional information provided by your distributors. In this case, the GD learns that:

- One of AOBC's main competitors, which held a 10% market share, has just gone out of business
- The market will rebound to 1993 levels by 1997, and the estimated annual growth rate for the next three years will be 10%
- There are no constraints to increasing production as AOBC is currently operating under capacity and raw materials are readily available in the market.

MARKET DATA	1993	1994	1995
Market size ('000 units)	500	200	250
AOBC's share	15%	15%	10%

Therefore, the GD assumes:

1997 sales will increase 50% from 1996 sales of 30,000, 20% in 1998, and then 10% from 1999 to 2001

ofcf2e/Page 16

Cash Inflow from Sales is also Dependent on Price, Inflation, Terms of Trade, and Production Strategy

Inflation

- AOBC plans to set its future prices equal to the current average price, adjusted for inflation. The current average sales price for its bikes is RUR 400,000
- The annual expected rate of inflation will be:

1996	1997	1998	1999	2000	2001
50%	30%	25%	20%	15%	15%

Production Strategy

- An important assumption is that AOBC will not produce for stock and all production is sold the same year as produced

Putting it all together, we arrive at the following forecasts:

(RUR'000)	1996	1997	1998	1999	2000	2001
Sales (units)	30,000					
Growth rate		50%	20%	10%	10%	10%
Total	30,000	45,000	54,000	59,400	65,340	71,874
Incremental		15,000	24,000	29,400	35,340	41,874
Inflation	50%	30%	25%	20%	15%	0
Unit price	400	600	780	975	1,170	1,346
Incremental Sales		9,000,000	18,720,000	28,665,000	41,347,800	56,341,467

ofcf2e/Page 17

<u>Explain:</u>

The incremental sales are those that AOBC believes it will garner based on the increased quality of its bike (those it would not have sold without undertaking the investment project)

Now, the General Director Projects Cash Outflows

Some important things to remember when doing cash outflow projections:

- Outflows include a number of expenses - production costs, overhead expenses, and taxes - requiring *inflation adjustments*
  - Inflation adjustments need to take into account cumulative inflation for the previous periods
  - It is easy to calculate the inflation adjustment factor for any year, if you know the estimated inflation rates
  - In this example the formula for 1999 will be:

$$\boxed{(1 + INFL^{96}) * (1 + INFL^{97}) * (1 + INFL^{98}) \text{ or } (1 + .5) * (1 + .3) * (1 + .25) = 2.44}$$

- Using this formula, the inflation adjustment factors for this example are:

1997: 1.5 1998: 1.95 1999: 2.44 2000: 2.93 2001: 3.36

- When forecasting production costs, remember that they may have *fixed* and *variable* components
  - We will now work through forecasting incremental cost components in detail, taking into account both their fixed and variable components

ofcf2e/Page 18

Instructor's Notes:

Explain:

Again, all outgoing cash flows estimated for the purpose of evaluating the investment project are those that are incremental to undertaking the project; i.e. they are not total outflows for bike production, but outflows relating to:

- production of additional bikes to be sold based on the increase in the quality of the bikes
- the decreased cost of production of all bikes produced based on increased yields from raw materials

42

The First Element of Production Costs to Consider is Raw Materials

Raw materials assumptions:

- Raw materials cost per unit (RMC) is currently equal to RUR 100,000. It is assumed that the price of raw materials will not change significantly and will increase according to annual inflation plus 2%
- AOBC management believes the investment in technology will allow increased yields from raw materials beginning in 1998 (after installation of equipment and training of the workforce). As a result, the cost of raw materials per unit should decrease by 12% as compared to 1996

Thus, the basic formulas for incremental costs of raw materials will be . . .

in 1997: $RMC^{96} * (Sales^{97} - Sales^{96}) * (1 + INFL^{96}+.02)$
from 1998: $RMC^{96} * (1-.12) * (Sales^{98} - Sales^{96}) * (1+INFL^{97}+.02) * (1+INFL^{96}+.02)$

. . . which results in the following projections:

- 1997: 100,000 * 15,000 * 1.52 = RU 2,280 m
- 1998: 100,000 * .88 * 24,000 * 1.32 * 1.52 = RU 4,238 m
- 1999: 100,000 * .88 * 29,400 * 1.27 * 1.32 * 1.52 = RU 6,593 m
- 2000: 100,000 * .88 * 35,340 * 1.22 * 1.27 * 1.32 * 1.52 = RU 9,668 m
- 2001: 100,000 * .88 * 41,874 * 1.17 * 1.22 * 1.27 * 1.32 * 1.52 = RU 13,402m

ofcf2e/Page 19

Projecting Raw Material Costs (cont.)

The decrease in raw material costs resulting from undertaking the project applies to all production, not only to incremental sales

The reduced cost of these materials are incremental cash savings resulting from the project, and need to be included in the project cash flows

The formula for these cost savings is . . .

$$\boxed{100{,}000 * .12 * 30{,}000 * (1+INFL^{98}+.02) * (1+INFL^{97}+.02) * (1+INFL^{96}+.02)}$$

. . . which results in the following incremental cost savings:

- 1998 100,000 * .12 * 30,000 * 1.32 * 1.52 = RU 722.3m
- 1999 100,000 * .12 * 30,000 * 1.27 * 1.32 * 1.52 = RU 917.3m
- 2000 100,000 * .12 * 30,000 * 1.22 * 1.27 * 1.32 * 1.52 = RU 1,119.1m
- 2001 100,000 * .12 * 30,000 * 1.17 * 1.22 * 1.27 * 1.32 * 1.52 = RU 1,309.4m

ofcf2e/Page 20

Re-emphasize:

Again, the decreased raw materials cost applies to all bikes to be produced, not only to the incremental sales resulting from the capital investment project.

Labor is the Second Key Element in Production Costs

Labor cost assumptions:

- As AOBC currently is not operating at full capacity, 25% of its workforce of 60 is presently on unpaid leave. Monthly wages currently average RUR 400,000 per employee. Thus 1996 annual wages will be:
  400,000 * .75 * 60 * 12 = 216,000,000
- Once the new equipment has been installed, the project will bring back employees currently on leave. Salaries will increase along with inflation.

Because wages increased in 1997 due to the implementation of the project, the difference between 1996 wages and 1997 wages will be an incremental cost:

400,000 * (60 - 45) * 12 * (1 + $INFL^{96}$)

- For annual production levels from 50,000 to 75,000 units, an additional 5 full time workers will be needed. It is expected that this level of production will be reached at the end of October 1998. The base salary of the additional workers will be set at the salary prevailing for the period, which will be:
  400,000*(1 + $INFL^{96}$)*(1 + $INFL^{97}$) = RU 780,000

Therefore, the 1998 incremental salary expense will have two components:

(780,000 * 15 * 12) + (780,000 * 5 * 2) = RU 148.2 m

In addition to wages paid to the workforce, total labor costs will include social security payments, which are 39% of salary expense.

ofcf2e/Page 21

Be sure to communicate to the audience the weighted component of additional workers salaries. It is expected that they will start working in November, and will be paid for two months only.

Projecting Labor Costs (cont.)

The following table summarizes the labor cost projections:

(RU '000)	1996	1997	1998	1999	2000	2001
Annual production (units)						
Total	30,000	45,000	54,000	59,400	65,340	71,874
Incremental		15,000	24,000	29,400	35,340	41,874
Inflation	50%	30%	25%	20%	15%	15%
Base salary	400	600	780	975	1,170	1,345.5
Employment						
Total		60	65	65	65	65
Incremental		15	20	20	20	20
Labor costs						
Total Salaries		432,000	569,400	760,500	912,600	1,049,490
Social Security		168,480	222,066	296,595	355,914	409,301
Incremental Salaries		108,000	148,200	234,000	280,800	322,920
Incremental Social Security		42,120	57,798	91,260	109,512	125,939
Total Incremental Labor costs		**150,120**	**205,998**	**325,260**	**390,312**	**448,859**

ofcf2e/Page 22

Energy is the Third Major Element of Production Costs

Electricity costs:

- In Russia, the industry is subject to political intervention which can lead to sharp changes in price
- Currently electricity tariffs are set in ranges. Above a certain level of electricity consumption higher tariffs are applied. The following represents the electricity costs per unit (EC) for the forecasted period:

Fixed electricity costs (independent of production levels): RUR 150 m
EC for annual production levels below 54,000 units: RUR 10,000
EC for annual production levels above 54,000 units: RUR 15,000

Note: electricity costs need to be adjusted for inflation

(RUR '000)	1996	1997	1998	1999	2000	2001
Annual production (units)	30,000					
Total		45,000	54,000	59,400	65,340	71,874
Incremental		15,000	24,000	29,400	35,340	41,874
Inflation	50%	30%	25%	20%	15%	15%
Fixed Electricity Costs	150,000	225,000	292,500	365,625	438,750	504,563
Electricity tariff 1 (per unit)	10.0	15.0	19.5	24.4	29.3	33.6
Total	300,000	675,000	1,053,000	1,316,250	1,579,500	1,816,425
Incremental		225,000	468,000	585,000	702,000	807,300
Electricity tariff 2 (per unit)	15.0	22.5	29.3	36.6	43.9	50.5
Incremental		-	-	197,438	497,543	901,855
Total incremental costs		225,000	468,000	782,438	1,199,543	1,709,155

ofcf2e/Page 23

Estimating Other Cash Outflows: Maintenance, Repair, and Taxes

Maintenance/Repair

- Costs per unit (MC) currently are 80% fixed and 20% variable, and amount to RU 10,000. Therefore in 1997 the formula for incremental project forecasted maintenance/repair costs will be:

$$[(.8 * MC^{96} * (1+INFL^{96}) * Sales^{96}) + (.2 * MC^{96} * (1+ INFL^{96}) * Sales^{96} * (Sales^{97}/Sales^{96}))] - MC^{96} * (1+INFL^{96}) * Sales^{96})$$

or

$$(.8 * 450 + .2 * 450 * 45,000/30,000) - 450 = RU\ 45\ m$$

This leads to the following incremental annual maintenance costs:

(RU'000)	1996	1997	1998	1999	2000	2001
Sales (units)	30,000	45,000	54,000	59,400	65,340	71,874
Inflation	50%	30%	25%	20%	15%	15%
Maintenance cost						
with project		495,000	678,600	874,575	1,084,239	1,290,832
w/o project	300,000	450,000	585,000	731,250	877,500	1,009,125
Incremental		45,000	93,600	143,325	206,739	281,707

***Taxes**: It's assumed that cumulative taxes are 40% of pretax profits.*

ofcf2e/Page 24

A Note on Depreciation

Assuming we are on a 5-year depreciation scale, the equipment purchased for AOBC's project will be depreciated by $240,000 each year

Depreciation is not a cash expense, but is tax deductible and therefore provides a tax shield. There are two possible ways to include depreciation into the cash flow forecast

- Deduct the depreciation expense from net income along with your other costs, effectively reducing your taxable base. Then, deduct taxes due on this reduced base, and then add back the depreciation to get your actual cash flow
- Or, do not deduct depreciation from your tax base, calculate and deduct taxes due on the entire base, and then add back a depreciation tax shield: depreciation multiplied by the tax rate

In this example, we will use the first method to account for depreciation

Note that only depreciation that occurs directly as a result of the project should be included

"Terminal Value" of the Project

If positive project cash flows continue in perpetuity, the usual practice is to forecast cash flows by year until the the project reaches a stabilized level of operations (stable growth and sustainable profit margins), with the year following being referred to as the "terminal year". The stable cash flows from then on are valued as a perpetuity ("terminal value")

With the high discount rates appropriate in Russia, however, the terminal value of most investment projects would probably be minimal

ofcf2e/Page 26

Note:

Because terminal values of projects in Russia are usually minimal, we will not go into detail about the means of calculating them.

Please refer to texts listed in the handout on reference materials for more information.

The Results of these Projections Combine to Form the Project's Forecasted Cash Flow

(RU '000)	1996	1997	1998	1999	2000	2001
Sales (incremental)						
Sales (units)		15,000	24,000	29,400	35,340	41,874
Revenues		9,000,000	18,720,000	28,665,000	41,347,800	56,341,467
Costs (incremental sales)						
Raw materials	3,000,000	2,280,000	4,238,000	6,593,000	9,668,000	13,402,000
Labor		108,000	148,200	234,000	280,800	322,920
Social Security		42,120	57,798	91,260	109,512	125,939
Electricity		225,000	468,000	782,438	1,199,543	1,709,155
Maintenance/Repair		45,000	93,600	143,325	206,739	281,707
Depreciation		240,000	240,000	240,000	240,000	240,000
Savings in raw materials			722,304	917,326	1,119,138	1,309,391
Earnings before taxes		6,059,880	14,196,706	21,498,303	30,762,344	41,569,137
Taxes (40%)		2,423,952	5,678,682	8,599,321	12,304,938	16,627,655
Earnings after taxes		3,635,928	8,518,024	12,898,982	18,457,406	24,941,482
Add back depreciation		240,000	240,000	240,000	240,000	240,000
Project cash flows		3,875,928	8,758,024	13,138,982	18,697,406	25,181,482
Working Capital needs		(2,700,120)	(2,305,478)	(2,838,425)	(3,620,571)	(4,377,127)
Initial investment	(1,470,000)	(400,000)				
Net Cash Flows	(1,470,000)	775,808	6,452,546	10,300,557	15,076,835	20,804,356

ofcf2e/Page 27

How Variable Is the Cash Flow of the Project You are Considering?

Two scenarios:

1) You are the economics director of a Russian company producing stainless steel. You have three foreign customers who have signed contracts to purchase $3 m total of your product in 1997

2) You are the economics director of a Russian enterprise which produces chocolate bars, which are sold in stores and kiosks. You have forecasted 1997 sales to be $3 m.

How likely is it that the sales of either company would be 5% less than forecasted?

As we said earlier, good cash flow projections must include best-case, worst-case and most-likely scenarios

ofcf2e/Page 28

Explain:

While expected sales might be the same for projects of the two enterprises listed, the potential variation is very different.

Sales of enterprise 1 are to millions of customers, and depend heavily on consumer preference. These customers can be fickle; tastes can change very quickly, and with such a large number of customers, it can be difficult to predict how much effect a new trend might have on forecasted sales, and therefore on the bottom line.

Enterprise 2 sells only to 3 major customers. It is easier, therefore, for the enterprise to set a realistic sales forecast. In the example given, these three customers have already signed form contracts for the company's product; it is therefore very unlikely that sales will be less than forecasted.

Cash Flow Projections Can be Impacted by Changes in the Operating Environment

Consider two more scenarios:

1) You are the economics director of an enterprise that makes garments, primarily by hand.
2) You are the economics director of a primary steel manufacturer.

If energy prices turn out to be 10% more than forecasted in the next year, how much of an effect will this have on the bottom line of project cash flows for each of these enterprises?

These types of considerations should go into your multiple-scenario cash flow forecasting

ofcf2e/Page 29

Note:

Slight changes in some inputs in the cash flow forecasts (such as energy prices) can have large effects on the bottom line of project cash flows for some enterprises. Every cash flow exercise should include "sensitivity" or "what if" analysis.

This means changing different inputs to the equation to see how sensitive the bottom line of the cash flows is to those inputs.

In this example, the enterprises would increase energy prices by 10% and see what percentage increase this had on net project cash flows.

A change in energy prices probably would impact the steel manufacturer more because it utilities much more energy than the garment maker.

Why Accuracy and Realism Are Important - An Example

You are a senior lending officer for a Moscow bank. AOBC has contacted you for a bank loan to finance a project to produce a new product - skateboards. The company has presented you with the following background information on the project.

- AOBC management believes that the skateboards will be a good complement to its current product range: strollers, tricycles and bicycles for teenagers. Statistics show a 25% annual growth rate for skateboards. Management forecasts first-year sales of 12,000 units
- The company wants to finish construction of a new production building which is 60% complete, where new equipment will be installed for the skateboard production line. AOBC currently has raw materials for producing 25,000 skateboards in its warehouse
- AOBC wants a long term loan to complete the building construction and to purchase the new equipment. The interest costs are included into incremental production costs, which amount to 80% of sales. The incremental working capital requirements will be financed as follows: 50% from teenagers bicycles sales and 50% from short term loans (at 80% annual interest)
- The company is presently operating at 50% capacity and is breaking even

ofcf2e/Page 30

[AOBC cash flow forecasts are on the following slide]

AOBC Skateboard Project: Projected Cash Flows

AOBC has provided you with the following cash flow forecasts

Will you finance the project?

Assumptions (all figures in $):

Sales in Year 1 (units)	12,000	
Price per unit	$ 45	
Annual Sales Growth Rate	25%	
Cost of Equipment	50,000	(depreciated over 10 years)
Cost of Construction	80,000	
Total Cost of Building	200,000	(depreciated over 25 years)
Cost for Production and Sales	80%	
Taxes	40%	of gross margin

	Year 0	Year 1	Year 2	Year 3
Sales (units)		12,000	15,000	18,750
Price per unit		45	45	45
Depreciation of equipment		5,000	5,000	5,000
Depreciation of building		8,000	8,000	8,000

	Year 0	Year 1	Year 2	Year 3
Sales		540,000	675,000	843,750
Cost of Production		(432,000)	(540,000)	(675,000)
Taxes		(43,200)	(54,000)	(67,500)
Investments	(130,000)			
Depreciation		13,000	13,000	13,000
Net Cash Flow	(130,000)	77,800	94,000	114,250

ofcf2e/Page 31

Emphasize:

Ask participants to look carefully at the forecasted cash flows for the project, check them with the text from the previous slide and answer whether they agree with the forecast or not. If not ask the audience to identify the bottle-neck of the cash flows.

The following slide has some aspects which require a closer look.

The AOBC Skateboard Project Cash Flows Need More Work

When analyzing the AOBC skateboard project cash flows beware of the following pitfalls:

- Need for additional capital to meet working capital requirements due to
  - Purchase of raw materials starting from year 2
  - Drop in sales of teenagers bicycles, as substitutes
  - Rise in accounts receivable
  - Barter sales
- The sales forecast is very optimistic
  - What is 25% annual growth based on?
- Consider the use of existing production buildings
  - Possible due to low utilization (50%)
  - Cheaper than completing construction

What adjustments will make the project cash flow more realistic and accurate?

	Year 0	Year 1	Year 2	Year 3
Sales		540,000	675,000	843,750
Cost of Production		(432,000)	(540,000)	(675,000)
Taxes		(43,200)	(54,000)	(67,500)
Investments	(130,000)			
Depreciation		13,000	13,000	13,000
Net Cash Flow	(130,000)	77,800	94,000	114,250

Emphasize:

Ask the audience what is the effect of each line item on the cash flows: no effect - increase - decrease:

•purchase of raw materials increases cost of production

•a drop in sales of bicycles increases the need of external financing, and thus interest costs

•a rise in accounts receivables increases the need for external financing, and thus interest costs

•sales for barter - depending on type of products obtained through in products:

no effect if skateboards are bartered for products needed in production (raw materials, services, etc.)

increases liquidity costs if skateboards are bartered for products designed for sale for cash or further bartering

•optimistic sales forecast decreases sales revenue

•use of existing production building decreases amount of initial investment

The Cash Flow Projections are then Used to Conduct a Financial Assessment of the Project

Let's assume AOBC has forecasted incremental cash flows for 5 projects under consideration. The cash flows look as follows:

Project Cash Flows

in Rubles, 000's

Year	Project A	Project B	Project C	Project D	Project E
0	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
1	0	20,000	1,000	0	5,000
2	5,000	20,000	5,500	0	10,000
3	50,000	2,500	8,000	30,000	15,000
4	55,000	20,000	22,000	40,000	20,000
5	30,000	20,000	46,000	50,000	20,000
Total	140,000	82,500	82,500	120,000	70,000

ofcf2e/Page 33

Emphasize:

The different projects presented in the table will be used for their financial evaluation applying 3 methods (NPV, IRR and cash payback).

Note the variations in cash flow patterns for the different projects - - all are negative in the first year, but then the patterns change, some rising slowly, some rising rapidly, and so on.

First, AOBC Will Evaluate these Projects Using Net Present Value (NPV)

Net Present Value (NPV) is the best tool for analyzing the financial feasibility of a project. It is the present value of future cash returns less the value of the initial investment which generates those returns.

- When using NPV, the present value of all future cash flows is discounted appropriately
- The discount rate is equal to the return required on investments of equal risk

$$NPV = [CF_1/(1+k) + CF_2/(1+k)^2 + CF_3/(1+k)^3 + \dots\dots + CF_n/(1+k)^n] - I_0$$

I_0 -- initial investment,

CF_n -- net cash flow in year n,

k -- discount rate

A project with positive NPV earns more than the required rate of return, i.e. more than the cost of capital, and therefore should be accepted. If projects are mutually exclusive then the project with the highest NPV should be selected

ofcf2e/Page 34

Emphasize:

NPV is considered the best financial evaluation method because it:

- **considers all appropriate cash flows**
- **discounts cash flows at the appropriate discount factor**
- **considers each project independently from all others**
- **selects projects which will maximize shareholder wealth**

The process of estimating a discount rate should not be taken lightly, and many large western firms expend considerable resources to understand the issues. They are interrelated with structuring financing and determining the optimal capital structure of a firm.

NPV methodology is only as good as the assumptions that went into determining the discount rate - and, of course, the projected cash flows.

[We will not go into great depth on this topic in this seminar, but a handout on calculating discount rates is included in the pack.]

Using NPV, AOBC Selects Project A

Assuming a 35% discount rate, NPV was calculated for each project. As you can see from the table, projects with similar net cash flows can have different net present values

- All the projects have positive NPVs and are acceptable investments.
- Projects C and D have lower NPVs and therefore are less attractive
- If the projects are mutually exclusive, the one with the highest NPV should be chosen
  - Therefore, project A should be selected

Year	*Project A*	Project B	Project C	Project D	Project E
0	**(20,000)**	(20,000)	(20,000)	(20,000)	(20,000)
1	**0**	20,000	1,000	0	5,000
2	**5,000**	20,000	5,500	0	10,000
3	**50,000**	2,500	8,000	30,000	15,000
4	**55,000**	20,000	22,000	40,000	20,000
5	**30,000**	20,000	46,000	50,000	20,000
Total	**140,000**	82,500	82,500	120,000	70,000
NPV	**26,315**	17,286	3,892	15,387	5,769

ofcf2e/Page 35

It is possible to think of a situation where the cash flows in total over the life of the project would all be equal, but NPV's are different because of the *timing*.

AOBC Now Evaluates its Projects Using Internal Rate of Return (IRR)

The internal rate of return (IRR) is defined as...

$$(CF_1/(1+IRR) + CF_2/(1+IRR)^2 + CF_3/(1+IRR)^3 + \dots\dots + CF_n/(1+IRR)^n) - I_0 = 0$$

In other words, it is the rate that makes a project NPV equal to 0

Some managers like IRR because it summarizes project information in a single number, without calculating a discount rate equal to the interest rate for investment projects of a similar risk (cost of capital)

But, managers must be careful using IRR:

- A project should be pursued if its IRR is higher than its cost of capital - otherwise, the company will **lose money pursuing the project**
- A project which includes future negative cash flows (after cash flows have been positive) will give multiple IRRs, which are difficult to interpret
- IRR does not take into account the size of a project
- IRR assumes that early positive cash flows are reinvested at the IRR rate - this is often unrealistic

ofcf2e/Page 36

Emphasize:

The IRR is an internal benchmark; it does not give an indication whether or not to proceed with a project unless it is compared to the enterprise's cost of capital.

However, there may be occasions when IRR is a useful measure for presenting the "attractiveness" of the project. If enterprise management is showing its proposed project to several investors and does not know their cost of capital, and therefore does not know an appropriate rate at which to discount the cash flows, the IRR may be a useful measure to present rather than a range of NPVs based on a range of discount rates.

Using IRR, AOBC Selects Project B

In this case, IRR produces a different result from NPV. This is because higher cash flows come earlier in the project life. IRR assumes that these cash flows will be reinvested at 83%. This is most likely not realistic, if the appropriate rate for calculating the NPV was 35%.

Year	Project A	Project B	Project C	Project D	Project E
0	(20,000)	**(20,000)**	(20,000)	(20,000)	(20,000)
1	0	**20,000**	1,000	0	5,000
2	5,000	**20,000**	5,500	0	10,000
3	50,000	**2,500**	8,000	30,000	15,000
4	55,000	**20,000**	22,000	40,000	20,000
5	30,000	**20,000**	46,000	50,000	20,000
Total	140,000	**82,500**	82,500	120,000	70,000
IRR	**71%**	**83%**	**41%**	**56%**	**47%**

NOTE: Another problem with the IRR method is that it is difficult to calculate accurately. The best way to do it is with a computer or programmable calculator.

ofcf2e/Page 37

Explain:

The basic rationale behind the Internal Rate of Return is to find a single number that summarizes the merits of a project and that doesn't depend on the interest rate that prevails in the capital market. It is an internal rate of return, intrinsic to the project, and does not depend on anything except the cash flows of the project.

AOBC Now Evaluates its Projects Using Cash Payback

The payback period is the number of years required to recover the initial investment in a project

Why it is used:

- It is simple
- It is good for ranking past decisions and providing a guideline for future ones

What managers should keep in mind when using cash payback:

- The cash payback method does not consider all cash flows from the project, because it ignores cash flows that occur after the payback period. In Russia, however, cash flow forecasts in later periods are extremely uncertain
- Cash payback method does not discount cash flows, i.e. it does not take into account the time value of money or the firm's cost of capital
- Cash payback does not help to choose between projects of different sizes

ofcf2e/Page 38

Emphasize

Drawbacks

Cash payback does not consider all cash flows, only those up to the payoff point. It is therefore biased against long-term projects.

It also does not take into account the time value of money. It treats all cash flows prior to the cutoff date equally.

It implies the required rate of return is 0

It ignores cash flows after the cutoff date

It is biased against long-term projects

Redeeming qualities

The payback period rule is easy to use and is often applied to relatively small decisions.

Since it can be used for small decisions, some companies permit its use (in the west) so that a manager's decisions can be evaluated more quickly. Using the NPV method, it could easily take 5 years (the end of the project) to evaluate the manager's decision. For a small project with a payback period of 2 years, the evaluation can be conducted much sooner.

Using Cash Payback, AOBC Selects Project B

According to the cash payback method project B should be selected, as it has the shortest payback period

Year	Project A	Project B	Project C	Project D	Project E
0	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
1	0	20,000	1,000	0	5,000
2	5,000	20,000	5,500	0	10,000
3	50,000	2,500	8,000	30,000	15,000
4	55,000	20,000	22,000	40,000	20,000
5	30,000	20,000	46,000	50,000	20,000
Total	140,000	82,500	82,500	120,000	70,000
Payback	**2.3**	**1**	**3.25**	**2.6**	**2.3**

ofcf2e/Page 39

This slide shows the evaluation of the projects shown above using the payback period method of review.

<u>Explain:</u>

The result of the review indicates project B as the preferred project because it has the shortest payback period. NPV analysis placed project A as the most advantageous. The difference results from the fact that the cash payback method does not take into account the time value of money and ignores cash flows that occur after the initial payback period.

Methods for Financial Evaluation of Projects: Summary

Year	Project A	Project B	Project C	Project D	Project E
0	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
1	0	20,000	1,000	0	5,000
2	5,000	20,000	5,500	0	10,000
3	50,000	2,500	8,000	30,000	15,000
4	55,000	20,000	22,000	40,000	20,000
5	30,000	20,000	46,000	50,000	20,000
Total	140,000	82,500	82,500	120,000	70,000
NPV	26,315	17,286	3,892	15,387	5,769
IRR	71%	83%	41%	56%	47%
Payback	2.3	1	3.25	2.6	2.3

When compared with NPV the other methods have the following limitations:

- **Payback:** Does not take into account the time value of money and ignores cash flows that occur after the initial payback period
- **Internal Rate of Return:** Does not take into account elements other than cash flows, supposes that these are reinvested at IRR's own rate (not always realistic)

ofcf2e/Page 40

NPV Calculation: In-Class Problem

AOBC plans to extend its product range and begin production of strollers. A currently unused production building will be used for the project. The building is currently worth RUR 800 million, and the enterprise will incur renovation costs of RUR 300 million

For the project new equipment for RUR 2 billion is required. Installation of the equipment (one-time expense of RUR 50 m) will be done by an outside contractor. The equipment will be depreciated on a straight-line basis for 5 years. Assume that the equipment will have no salvage value after 5 years

Incremental production costs as a percent of sales are:

- Spare parts - 40%
- Raw materials - 20%
- Electricity - 5%
- No additional workers are required for stroller production

ofcf2e/Page 41

This slide and the next slide present a problem to work in class with the participants.

NPV Calculation: In-Class Problem (continued)

Current ex-factory price for strollers is RU 300 000. It is believed that the price will increase in accordance with inflation rate

The anticipated inflation is: 25% for the current year; 20% for years 1 - 3; 15% for year 4 and 10% for year 5

AOBC has discussed the project with its current distributors, who predict annual unit sales to reach:

Year 1: 10,000	Year 2:12,000	Years 3-5: 20,000

The profit tax for children's goods production is 25%. This rate will not be changed during the life of the project

AOBC will finance the project with its own funds (i.e. no interest costs are incurred)

Assignment: Forecast net project cash flows and calculate the NPV of the project assuming an 80% discount rate

ofcf2e/Page 42

The following 3 slides show the step-by step solution to the problem.

Solution: Creating an Algorithm

Identify cash flows relevant to the project

- Initial cash outflows
  - renovation of the building
  - new equipment purchase
  - installation
  - increase in working capital
- Annual cash outflows
  - cost of production
  - taxes
- Annual cash inflows
  - proceeds from sales

Quantify all relevant cash flows

- Adjust for inflation

Calculate net cash flow for each year

- Add back depreciation (non-cash expense)

To get NPV, discount net cash flows

ofcf2e/Page 43

Stop and give seminar participants time to consider how to calculate each step

- **initial cash outflows**
- **annual cash outflows**
- **annual cash inflows**
- **net cash flow for each year**

Methodology is shown on the following slide

Solution: Calculating Net Project Cash Flow

Add all initial outflows:

- 2,000 m + 300 m + 50 m = 2,350 m

Annual sales are:

- Units sold * price per unit adjusted for inflation

Annual incremental costs are:

- Production costs (40%+20%+5%)
  - annual sales * 65%
- Taxes
  - (annual sales - production costs) * tax rate

Add back depreciation

- Sales - production costs - taxes + depreciation = net cash flow

ofcf2e/Page 44

Give seminar participants time to make the calculations to arrive at net cash flow per period. Have them write down the answers.

(Answers are shown on the following slide)

Solution: Cash Flow Forecast

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Sales volume (in units)		10,000	12,000	20,000	20,000	20,000
Inflation for the period	25%	20%	20%	20%	15%	10%
Sales price	0.30	0.38	0.45	0.54	0.65	0.75
Sales revenue		3,750	5,400	10,800	12,960	14,904
Royalty payments		0	0	0	0	0
Raw materials		-750	-1,080	-2,160	-2,592	-2,981
Electricity		-188	-270	-540	-648	-745
Gas and water		0	0	0	0	0
Spare parts		-1,500	-2,160	-4,320	-5,184	-5,962
Depreciation-Building						
Depreciation-Equipment		-100	-100	-100	-100	-100
Wages		0	0	0	0	0
Overhead expenses						
Earnings before taxes		1,213	1,790	3,680	4,436	5,116
Taxes		-303	-448	-920	-1,109	-1,279
Earnings after taxes		909	1,343	2,760	3,327	3,837
Add back depreciation		100	100	100	100	100
Project cash flows		1,009	1,443	2,860	3,427	3,937
Working capital needs						
Capital investment	-2,350					
Salvage value						
Net Cash Flows	-2,350	1,009	1,443	2,860	3,427	3,937

ofcf2e/Page 45

Have participants check their calculations with the calculations in the slide.

Solution: Discount Factor Calculation

To get the discount factor two approaches may be used:

First: Use the formula $1/(1+k)^n$, where k -- discount rate (80%) and n -- corresponding years (1 through 5). Thus, the discount factor by years will be:

Year 1: $1/(1+0.8)^1$	Year 1: **0.556**
Year 2: $1/(1+0.8)^2$	Year 2: **0.309**
Year 3: $1/(1+0.8)^3$	Year 3: ________
Year 4: $1/(1+0.8)^4$	Year 4: ________
Year 5: $1/(1+0.8)^5$	Year 5: ________

ofcf2e/Page 46

Explain:

Be sure to communicate the audience how the formula for calculating the discount factor works. Stop and ask the participants if any have a calculator with them with which they can do the calculations. If so, ask them to calculate the discount factors for years 3 through 5 and write them into the spaces provided.

Solution: Discount Factor Calculation (continued)

To get the discount factor two approaches may be used:

Second: Use the discount factor table.

	Discount Rate				
Period	70%	75%	**80%**	85%	90%
0	1.000	1.000	**1.000**	1.000	1.000
1	0.588	0.571	**0.556**	0.541	0.526
2	0.346	0.327	**0.309**	0.292	0.277
3	0.204	0.187	**0.171**	0.158	0.146
4	0.120	0.107	**0.095**	0.085	0.077
5	0.070	0.061	**0.053**	0.046	0.040
6	0.041	0.035	**0.029**	0.025	0.021
7	0.024	0.020	**0.016**	0.013	0.011
8	0.014	0.011	**0.009**	0.007	0.006
9	0.008	0.006	**0.005**	0.004	0.003
10	0.005	0.004	**0.003**	0.002	0.002

- Using the above table, the discount factor for years 2-5 will be:

Year 1: **0.556** Year 2: ________ Year 3: ________

Year 4: ________ Year 5: ________

ofcf2e/Page 47

Explain:

Be sure to communicate to the audience how to use the Discount Factor Table and explain how it works: chose the column with appropriate discount rate (80%) and check the rows in the required years. Stop and ask the participants to fill into spaces provided from the Table, the discount factors for years 2 through 5.

Solution: NPV Calculation

The following table represents NPV calculation at 80% discount rate

Year	Net Cash Flow *A*	Discount Factor *B*	Discounted Cash Flow *C*
1	1,009	0.556	561
2	1,443	0.309	445
3	2,860	0.171	490
4	3,427	0.095	326
5	3,937	0.053	208
Add up: Present Value			2,031
Subtract: Initial Investment			-2,350
Net Present Value			-319

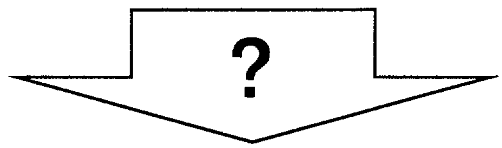
ofcf2e/Page 48

The discounting is too complex for the participants to do in the seminar. Note that this can easily be done in all computer spreadsheet programs.

This project should not be selected for financing, because it has negative NPV.

Moving from Project Selection to Obtaining Finance

This section introduced the tools that allow you to select the right projects for your company



Once a project is selected, the next question is how it will be financed. The following two sections of the seminar will focus on sources of short term and long term financing.

ofcf2e/Page 49

In this section we have covered:

- strategic evaluation of projects
- financial evaluation of projects, including

  cash flow forecasting,

  and use of NPV, IRR, and cash payback

Next we will discuss specific sources of financing.

Seminar Agenda

Session 1: Finance Overview

Session 2: Project Selection

Session 3: Sources of Short-Term Finance

Session 4: Sources of Long-Term Finance

Session 5: Preparation, Approach, Negotiations

Session 6: Specifics of a Business Plan, Investment Memorandum, and Issue Prospectus

Session 7: Company Valuation

Session 8: Summary

ofcf3e/Page 1

Instructor's notes:

In this section of the seminar we will discuss potential sources of short term finance, and run through how to go about selecting which is best to fit the needs of the enterprise.

Is Your Enterprise Considering All Forms of Short-Term Finance?

Options for external short term finance for Russian enterprises include:

- Trade credit
- Tolling
- Short term bank finance
- Mutual settlement/offset
- Commercial paper/notes
- Sale or discounting of accounts receivable (factoring)
- Short term operating leases

ofcf3e/Page 2

Instructor's notes:

Emphasize:

As discussed previously, the cheapest source of short term financing is generally internally generated funds through good management of working capital. In this section of the seminar we will discuss external sources of short term financing.

Of those listed, the most commonly available to Russian enterprises are those at the top of the list:

- Trade credit
- Tolling
- Bank finance
- Mutual settlement/offset

Sources of Short-Term Finance Differ in Terms of Flexibility and Cost

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Trade credit	●	◔	●	●	rolling	medium
Tolling	◔	◑	○	◔	rolling	high
Bank finance	●	●	◔	◕	rolling	high
Mutual offset	◑	◑	◑	●	rolling	medium
Commercial paper	●	◑	◑	◑	rolling	medium
Factoring	●	◑	○	○	rolling	high
Leasing	○	◑	○	◑	rolling	low

most flexible ● ◕ ◑ ◔ ○ least flexible

ofcf3e/Page 3

Instructor's notes:

Explain:

This slide shows how flexible the different sources of financing are for different situations. The darker the circles, the more flexible. We will continue to discuss this throughout the rest of this section, and conclude the section with the steps to go through in choosing the best source.

In contrast to "one time" "rolling" means that the financing will be available again for a following period under the same conditions, though the conditions may be changed by he financier.

Trade Credit is the Most Common Source of Financing in Russia

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Trade Credit	●	◔	●	●	rolling	medium

Trade credit is credit received from suppliers in the normal course of business

Trade Credit appears to be free, but there is usually a hidden cost

- A supplier extending trade credit incurs an opportunity cost of funds invested in accounts receivable
- The supplier will usually pass on most of this cost in the form of a higher price. The amount that is passed on will depend on market conditions and the relative bargaining power of the two parties
- A cash discount can usually be negotiated in the case of immediate payment

Before accepting trade credit, you should find out the discount available for cash payment, and compare that option with other forms of financing

ofcf3e/Page 4

Instructor's notes:

Emphasize:

Trade credit is usually an informal arrangement, not formally (legally) acknowledged as debt and practically recorded as accounts payable

Trade credit grows with growth in the business and extension in credit period

The user of trade credit needs to be aware of the actual cost incurred in order to make intelligent financing decisions

The implicit cost of trade credit should be compared with the cost of other available sources of short term finance

[The examples illustrated on the following slide demonstrate the cost of trade credit]

Exercise 3.1: Trade Credit Analysis

Situation:

- You currently need cash for the purchase of raw materials, and are considering the possibility of receiving trade credit from your long term supplier
- On average you have paid for shipments within 30 days, and now the supplier is offering a 10% discount for immediate cash payment on a shipment worth RUR 100 million. The discount rate is negotiable. A bank loan at 10% per month is available to finance immediate payment for the raw materials
- You expect to collect outstanding accounts receivable worth RUR 200 million within 30 days

Assuming no monthly inflation and ignoring tax effects for the purpose of simplification, decide whether it is appropriate to take the discount for immediate payment

ofcf3e/Page 5

Instructor's notes:

Exercise 3.1: Trade Credit Analysis (continued)

There are two options available:

- First: Accept the discount, and get a loan for 30 days at 10% to pay for the shipment
- Second: Do not take the discount, instead receiving trade credit for 30 days, until making payment with cash collected from settlement of accounts receivable

Calculation of acceptable discount (no inflation assumed):

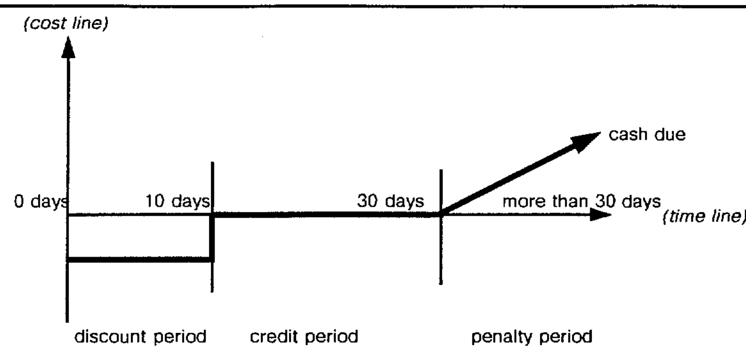
- If discount is taken the amount due is RUR 90 m = (100 m * (1 - 0.1))
- The interest for RUR 90 million loan is RUR 9 m = (90 m * 0.1)
- At the end of 30 days, you pay back 99 m - a net gain of 1 m
- If you accept the trade credit, you pay 100 m at the end of 30 days

Decision → **Take the Discount**

ofcf3e/Page 6

Instructor's notes:

Is Trade Credit Free ?



Credit policies of suppliers usually include terms of credit, for example, 2/10, net 30, which means a 2% **discount** will be given for payment completed within 10 days after the date of invoice; no discount or extra fees would be implied for payment between 10 to 30 days after the invoice date and **penalties** will be imposed on the purchaser failing to pay off the invoice within 30 days

Careful consideration needs to be given to the cost of trade credit for each of the three periods in comparison to other credit options, e.g. bank loan etc.

Instructor's notes:

<u>Explain</u>:

The 2% discount is an incentive to pay early, so the seller does not have to immobilize funds for more than 10 days.

It is part of the actual cost of financing over 30 days.

If the buyer pays after 30 days, he pays everything plus penalties (additional financing fees)

Again, these costs of financing must be compared to the costs of other types of short term financing to determine which is the cheapest option

Tolling is a Means of Securing Raw Materials for Production, but Care Must be Taken to Ensure Economic Benefits Accrue to the Processor

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Tolling	◔	◑	○	◔	rolling	high

Tolling is a means by which a processor is provided with raw materials at no cost, processes them and returns the finished product to the owner. The processor is compensated by the supplier for this work

- Payments for tolling may be in cash or in a share of the finished product
- Economic benefits primarily accrue to the owner of materials, who sells the finished product to the end user; the processor is paid only a processing fee. The processor must take care to ensure he is being adequately compensated
- Tolling is in some cases subject to government quotas

most flexible ● ◕ ◑ ◔ ○ least flexible

ofcf3e/Page 8

Instructor's notes:

<u>Example</u>:

A Russian clothing manufacturer is provided fabric and patterns free of charge by a German clothing distributor. The Russian company produces the clothing, which is returned to the German firm to distribute in western Europe. The Russian company is paid a set fee for sewing each garment.

<u>Another example</u>:

A Russian producer of stainless steel receives steel coils from a US metals trading company. The Russian company processes the coils into stainless steel, which it ships to the US firm. The US firm pays a processing fee to the Russian processor.

Who Might Utilize Tolling?

The owner of the raw material uses tolling if:

- The owner is not also a processor
- The owner does not have the capacity to process all material owned, and for which a market exists
- Another entity can process the materials at a much lower cost than the owner

A processing company may resort to tolling if:

- It currently has no other means of financing or otherwise acquiring raw materials, and wishes to continue operations with the expectation that he will have other options for acquiring materials in the near future
- It needs to increase capacity utilization in order to spread fixed costs between tolling and non-tolling operations, making non-tolling operations more profitable

ofcf3e/Page 9

Instructor's notes:

Emphasize:

Tolling is extremely prevalent in Russia today, as so many companies are strapped for working capital for purchase of raw materials.

It is usually not in the best interest of the Russian enterprise - the enterprise must be sure it is being paid a processing fee high enough to make it worthwhile.

Generally, it is better for the Russian firm to engage in non-tolling operations rather than tolling operations if given the choice, unless there is a strategic reason to build a better trade relationship through tolling with the owner of the materials

Short-Term Bank Finance Can be Expensive

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Bank Finance	●	●	◔	◕	rolling	high

Short term bank financing can be separated into:

- Overdraft facilities - the ability to withdraw more funds than on deposit
- Short-term bank loans

Facts about overdraft facilities:

- Costs depend on actual amount used and number of days of overdraft
- Rates vary considerably among banks - in mid-1995, the annualized rate for ruble overdrafts of 1 to 14 days varied by more than 100%
- Advantages include flexibility and ease of renewal/rollover
- Major disadvantage: currently available only to a small number of well known enterprises

Short term loans:

- Relatively less flexible than overdrafts, and the cost may be higher

most flexible ● ◕ ◑ ◔ ○ least flexible

Instructor's notes:

Emphasize:

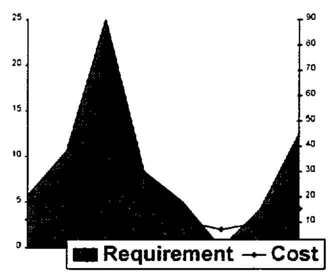
The decision to use overdraft/cash credit facilities depends on the structure of the company's cash requirements, and their ability to use lower cost sources of financing such as trade credit and customer advances to minimize their requirements.

In Russia today, cash credit and overdraft facilities are not easily available. Short term finance from commercial banks is likely to develop over the next few years.

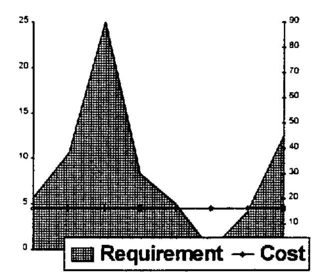
Overdrafts and Bank Loans Have Different Costs

The cost of an overdraft is dependent on the amount of cash needed at a specific time and can be controlled by the borrower	The cost of bank credit remains constant as stipulated by a credit agreement with the bank; the borrower should pay all interest throughout the period of the loan

Cost Structure of Overdraft



Cost Structure of Loan



ofcf3e/Page 11

Instructor's notes:

Explain:

The advantage of using an overdraft or cash credit facility is that the borrower pays only for the financing required and used. There is however a fixed cost component for availing of this facility.

A company with high seasonality of demand or a short production cycle would find overdraft facilities a lower cost option.

Mutual Offset is a Typical Form of Settlement Between Russian Suppliers and Purchasers

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Mutual Offset	◑	◑	◑	●	rolling	medium

Mutual offset is the settlement of cash obligations between companies by delivery of goods between two or more parties

While these are non-cash transactions, any receipt of goods from a supplier before delivery of goods to another party equates to short term borrowing

Offset operations currently constitute more than 70% of sales among the largest production companies in Russia, constituting a significant source of financing

most flexible ● ◕ ◑ ◔ ○ least flexible

ofcf3e/Page 12

Instructor's notes:

Mutual offset, barter, and commercial paper are all related.

Barter can be considered a form of mutual offset where the goods received from a customer in payment are not raw materials of the seller.

Currently Commercial Paper/Notes Are A Limited Option in Russia

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Commerical Paper	●	◑	◑	◑	rolling	medium

Commercial paper/notes normally represent a company's promise of delayed payment

- Unsecured, low cost alternative to trade credit; used as cash equivalent for operating receipts and payments when in a cash squeeze
- A stable market exists for notes issued by commercial banks, e.g. Inkombank
- The secondary market for notes issued by other companies is limited - only a few companies have had successful issues, e.g. Avtovaz, Komineft; usually the market for such securities is limited to trade partners

most flexible ● ◕ ◑ ◔ ○ least flexible

ofcf3e/Page 13

Instructor's notes:

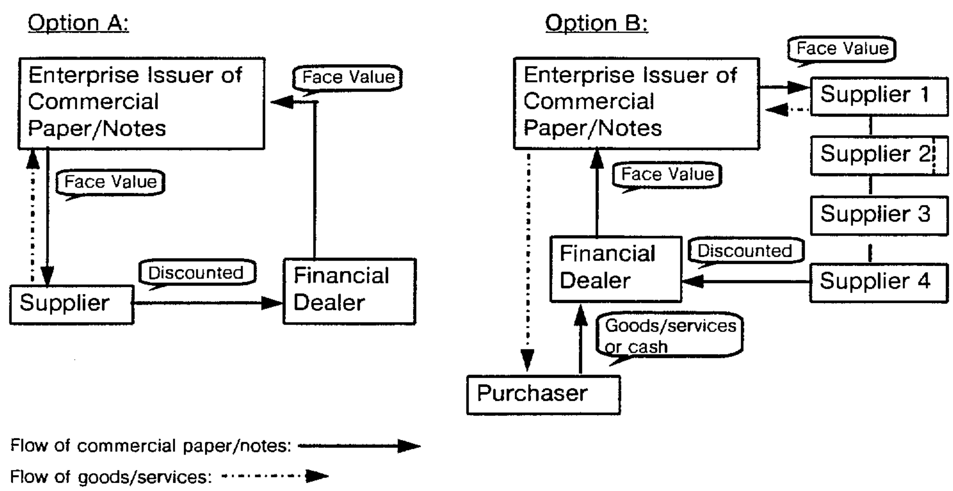
<u>Explain</u>:

Commercial paper of an enterprise is often used as promissory notes in mutual offset transactions (explained later).

In western markets, there is an active secondary market for commercial paper and notes, whereas in Russia the range of dealers in such securities is limited to trade partners - there is a fairly active market for KamAZ notes amongst the company's materials and parts suppliers who receive the notes instead of cash, and KamAZ trade distributors and end users who buy the notes at a discount and afterwards claim full redemption from KamAZ

The graphic on the following page illustrates how commercial paper is traded between suppliers, customers, and banks in Russia.

How is Commercial Paper Used in Russia?



ofcf3e/Page 14

Instructor's notes:

<u>Explain</u>:

<u>Option A: One Russian enterprise's notes accepted as payment by one supplier</u>. This is the most simple example of this type of settlement. The supplier ships goods and accepts promissory notes in return, which it sells at a discount to a financial institution. The financial institution then collects the face value of the notes from the buyer at redemption date. This is also called forfeiting.

<u>Option B: Two Russian enterprises issuing promissory notes, with the notes being passed down a "chain" of suppliers</u>. This is a more realistic case in the Russian environment. The concept is the same as in option A.

<u>Note</u>:

There have been some horror stories of enterprises getting caught with illiquid paper. <u>Be careful whose paper you accept as payment!</u>

Factoring (Sale or Discounting of Accounts Receivable) is Also Limited in Russia Today

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Factoring	●	◑	○	○	rolling	high

Factoring works as follows:

- Once goods have been received by a buyer, the seller can receive immediate cash from the factoring bank discounted 10-40% depending on the creditworthiness of the buyer and the quality of the goods
- The factoring firm then collects payment from the buyer on the date due

The advantage to factoring is that it allows the seller to maintain liquidity

The disadvantages are that factoring is expensive, limited in Russia, and usually reserved for bank clients

most flexible ● ◕ ◑ ◔ ○ least flexible

ofcf3e/Page 15

Instructor's notes:

<u>Background</u>:

Factoring is a common form of short term finance in western markets.

Tokobank and Unikombank have offered factoring services in the past.

Large and more experienced Russian commercial banks began offering factoring services to their clients in 1992, however, high inflation, the increase of fraudulent payment documents, and the insolvency crises has limited the development of this source of finance in Russia.

Therefore, this source of financing is extremely limited at the present time because it requires stability of the environment and general "good faith" from all parties involved to work properly.

You should check with your bank to see if they provide factoring services or if they know of a bank that does.

Short-Term Leases Can Save Cash Investment on Equipment the Enterprise Needs for a Limited Period of Time

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Leasing	○	◑	○	◑	rolling	low

Advantages of short term leases:

- Alternative to small capital expenditure
- Matches cash outflows to cash inflows resulting from use of the asset
- Useful if lessee does not intend to use the asset over its full economic life, e.g. leasing transportation for a short period, leasing computers and office equipment
- Lessee pays for 'convenience' as lessor is usually responsible for maintenance

most flexible ● ◕ ◑ ◔ ○ least flexible

ofcf3e/Page 16

Instructor's notes:

The financial tradeoffs of the lease vs. buy decision are covered in the cash management seminar.

Leasing will be described in more detail when we discuss sources of long term finance.

With Knowledge on the Different Types of Financing Available, How do You Select the Right One for Your Project?

Step 1:	Consider the most important issues: What will the funds be used for? How much is required? What collateral is available? How quickly are the funds needed?	Use: raw materials acquisition Amount: US$ 40,000 Collateral: finished goods Time frame: fairly urgent
Step 2:	List potential sources of finance for your project.	Trade credit, bank finance, mutual offset, commercial paper
Step 3:	Rank them in order from least expensive to most expensive.	1. Mutual offset 2. Trade credit 3. Commercial paper 4. Bank finance
Step 4:	Begin by pursuing the least expensive source of finance and work down the list. You may have to obtain financing from several sources.	~~1. Mutual offset~~ 2. Trade credit 3. Commercial paper 4. Bank finance

ofcf3e/Page 17

Instructor's notes:

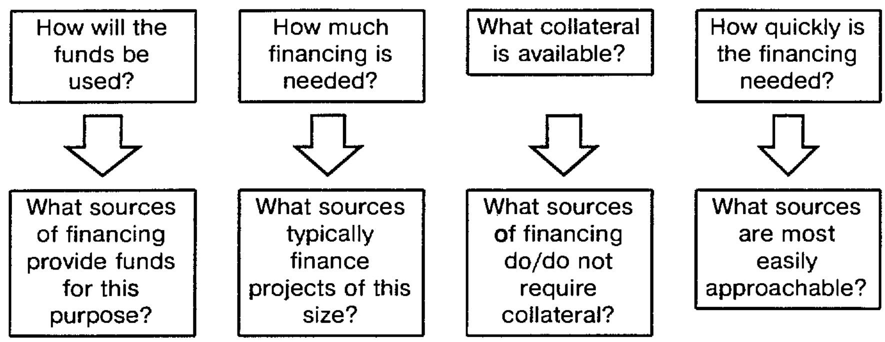
The options listed will not always be in this order in terms of cost (mutual offset will not always be cheaper than trade finance, for example); this depends on the company's bargaining position with the different sources of finance. This ranking is shown for example purposes only.

Emphasize:

Financing from several sources may be required for a single project, either because of the size of its requirements, or because of the nature of its components, or because of complexity.

Choosing the Appropriate Source: Start by Considering the Most Important Issues

Ask yourself the following questions . . .



ofcf3e/Page 18

Instructor's notes:

[Each of these "criteria" for selecting appropriate sources of short term finance will be explained separately, in the next four slides.]

Choosing the Appropriate Source (cont.)

. . . and use the chart to help you find the right answers

	restrictions on use of funds	amount of financing	collateral requirement	accessbility	one time/ rolling	cost
Trade credit	●	◔	●	●	rolling	medium
Tolling	◔	◑	○	◔	rolling	high
Bank finance	●	●	◔	◕	rolling	high
Mutual offset	◑	◑	◑	●	rolling	medium
Commercial paper	●	◑	◑	◑	rolling	medium
Factoring	●	◑	○	○	rolling	high
Leasing	○	◑	○	◑	rolling	low

most flexible ● ◕ ◑ ◔ ○ least flexible

ofcf3e/Page 19

92

The Use of the Funds is a Major Determinant in Selecting a Financing Option

How will the funds be used?

- You can obviously only use leasing as a source of short term finance if you plan to acquire equipment
- Trade credit and tolling can only finance acquisitions of raw materials
- Mutual offset can only be used with suppliers of materials, energy, etc.
- Bank finance, commercial paper, and factoring are more flexible, but usually more expensive - flexibility has a cost

ofcf3e/Page 20

Instructor's notes:

Any external short term financing option frees up cash that can be used elsewhere, introducing flexibility. For example, if you need funds to pay salaries and are currently paying cash for raw materials, you may consider mutual offset to finance raw materials purchases and use the excess cash to pay salaries.

The Amount of Financing is Also a Key Consideration

How much financing is needed?

- Specific asset financing is limited to the value of the assets to be purchased
- In addition, financing through the use of commercial paper will be limited in most cases by the ability of trade partners to finance your operations
- The amount of funds you can raise through factoring will be limited to the discounted value of your accounts receivable
- Bank financing will most likely be the source of the largest amount of funds

ofcf3e/Page 21

Instructor's notes:

ℊℊ

Different Short-Term Financing Methods Require Different Types of Collateral

What collateral is available?

- Factoring, leasing and tolling finance will always be guaranteed by underlying assets
- You will most likely need to provide some additional collateral to obtain bank financing
- Trade credit, mutual offset and commercial paper financing may be unsecured

ofcf3e/Page 22

Instructor's notes:

If You Need Immediate Financing, Your Options are Limited

How quickly is the financing needed?

- How quickly you can get the financing depends on the ease with which you can approach the financing source and the documentation you must prepare
- Tolling will involve looking for a partner and structuring a transaction; this will take some time
- Trade credit and mutual offset will probably be your quickest means of financing

ofcf3e/Page 23

Instructor's notes:

qb

Once You Have Identified Appropriate Sources, Rank Them in Terms of Cost

Step 1:	Consider the most important issues: What will the funds be used for? How much is required? What collateral is available? How quickly are the funds needed?	Use: raw materials acquisition Amount: US$ 40,000 Collateral: finished goods Time frame: fairly urgent
Step 2:	List potential sources of finance for your project.	Trade credit, bank finance, mutual offset, commercial paper
Step 3:	Rank them in order from least expensive to most expensive.	1. Mutual offset 2. Trade credit 3. Commercial paper 4. Bank finance
Step 4:	Begin by pursuing the least expensive source of finance and work down the list. You may have to obtain financing from several sources.	<u>1. Mutual offset</u> 2. Trade credit 3. Commercial paper 4. Bank finance

ofcf3e/Page 24

Instructor's notes:

The options listed will not always be in this order in term of cost (mutual offset will not always be cheaper than trade finance, for example); this depends on the company's bargaining position with the different sources of finance. This ranking is shown for example purposes only.

<u>Emphasize</u>:

Financing from several sources may be required for a single project, either because of the size of its requirements, or because of the nature of its components, or because of complexity.

Exercise 3.2: Choosing Source(s) of Short-Term Financing

Assumptions:

- You have an order that provides you with an unusually high margin
- You will get payment within 30 days and now need to pay RUR 100 million for railroad transport
- You have RUR 75 million on your bank account for payroll, which is due in two weeks. Some other payments are expected to come in within the next month

Structure the best financing from the following available sources (disregard inflation):

- Overdraft of existing loan (interest - 10%, overdraft - 15% per month)
- Railroad commercial paper available from your bank at 25% discount
- Loan from local bank (12% per month)
- Offset of your accounts receivable (worth RUR 250 million) for raw materials (your partner offers you to pay off his debt with raw materials used by your company)
- Sale of your accounts receivable/factoring (worth RUR 200 million) at 40% discount

ofcf3e/Page 25

Instructor's notes:

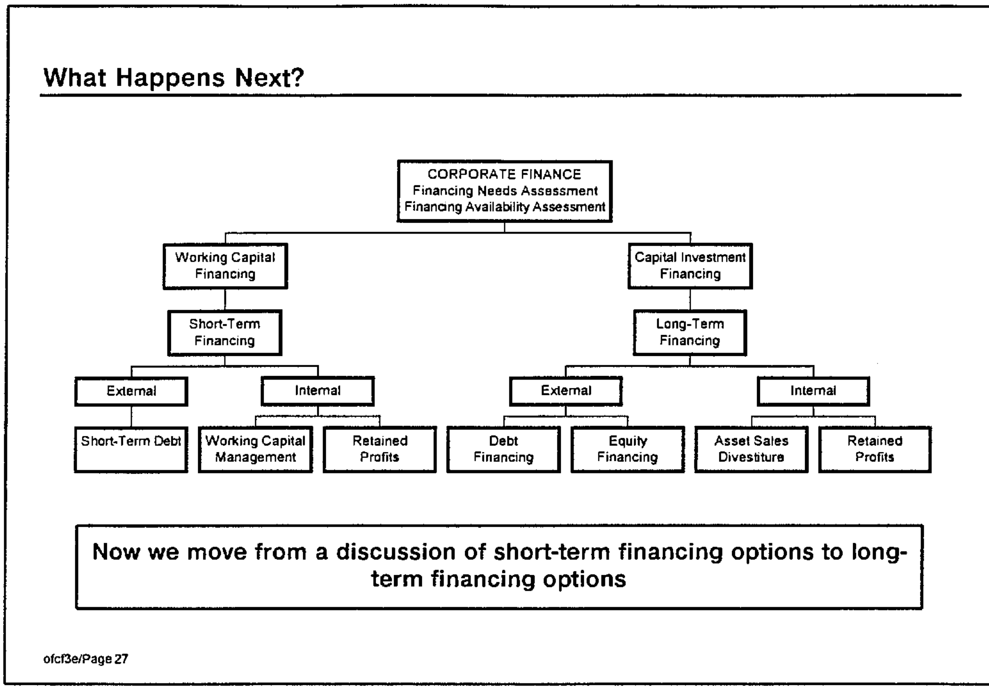
Explain again, quickly, each item before the audience starts working.

Exercise 3.2: Choosing Source(s) of Short-Term Financing (continued)

- *This order is top priority, thus payment for railroad transportation must be made*
- *The RUR 75 million on your bank account is enough to pay for transportation by means of railroad commercial paper available from your bank at 25% discount*
- *The payroll due in two weeks may be financed through other sources:*
  - Any cash settlement of previous orders (accounts receivable)
  - Bank loans (RUR 75 million if no payments received or balance required if payments received are less than RUR 75 million) for a short period until the payment is received
    - Overdraft
    - New loan
- *Offset of accounts receivable does not involve cash, thus can be considered only to the extent of freeing up cash (if any) planned for purchase of raw materials*
- *Sale of accounts receivable is a very expensive option because of the huge discount incurred*

ofcf3e/Page 26

Instructor's notes:



Instructor's notes:

Explain:

In this section, we have looked at sources of short term financing for working capital (the left side of the chart)

In the following section we will discuss sources of long term financing (right side of the chart).

Seminar Agenda

Session 1:	Finance Overview
Session 2:	Project Selection
Session 3:	Sources of Short-Term Finance
Session 4:	**Sources of Long-Term Finance**
Session 5:	Preparation, Approach, Negotiations
Session 6:	Specifics of a Business Plan, Investment Memorandum and Issue Prospectus
Session 7:	Company Valuation
Session 8:	Summary

ofcf4e/Page 1

Instructor's notes:

In this section we will look at the long term sources of finance.

Long-Term Finance is Necessary for the Growth and Development of Your Enterprise

You will need long term financing to:

- Develop/acquire new technologies
- Purchase modern equipment
- Develop new products or enhance existing products
- Build distribution networks
- Improve management reporting systems

These types of projects are necessary for you to stay ahead of the competition.

Start planning now how you will fund your future development!

Management will need to secure the support of major shareholders before beginning to negotiate long-term financing. Shareholders will need to be convinced of the importance of funding development projects.

In this section of the seminar, we will cover:

- Sources of long term financing available for Russian enterprises
- Decision criteria for choosing among these potential sources
- How to go about deciding which financing option to pursue

ofcf4e/Page 2

Instructor's notes:

[This slide re-emphasizes the need for long term financing, and then explains what will be covered in this section]

There are Many Options for Long-Term Financing

- **Currently-used sources of long-term financing**
  - **Russian banks**
  - **Foreign banks**
  - **Portfolio investors - private funds**
  - **Portfolio investors - "Aid" funds**
  - **Strategic investors**

- Other, less frequently-used, but emerging sources of long-term financing
  - Public issues of shares/rights (Russian and foreign, including ADR/GDRs)
  - Bonds
  - Convertible bonds
  - Leasing

ofcf4e/Page 3

Instructor's notes:

Sources of Long-Term Finance Vary in Terms of Flexibility, Lending Criteria, Availability and Cost

	amount of financing	company size	project risk	Investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Russian banks	◕	●	◔	●	medium	medium	●	yes	medium
Foreign banks	●	◔	○	◕	high	high	◔	yes	medium
Private funds	◕	◑	◔	◔	medium	high	◑	maybe	low
Aid funds	◑	●	◕	◑	medium	low	◕	maybe	low
Strategic investors	●	◑	◑	○	high	medium	◔	yes	low
Public issues	◑	◔	◔	◕	high	medium	◔	no	medium
Bond issues	◔	○	○	◕	high	high	○	no	high
Convertible bonds	◑	◔	◔	◑	high	medium	○	no	medium
Leasing	◔	●	○	●	low	low	●	yes	low

most flexible ● ◕ ◑ ◔ ○ least flexible

ofcf4e/Page 4

Instructor's notes:

<u>Explain:</u>

This slide shows how flexible different sources of financing are for different situations. The darker the circles, the more flexible. We will continue to discuss this throughout the rest of this section, and conclude the section with steps to go through in choosing the best source. **[A contact list for Russian banks, foreign banks, private funds, and aid funds is included in the handouts.]**

Amount of financing indicates the degree to which sources of finance can provide varying amounts of funds. For example, foreign banks and strategic investors are flexible in making investments that range from small projects up to very large ones.

Company size indicates the degree to which sources of finance target a particular type of company to grant financing to. For example, only the largest and most well known firms will be able to access financing from bond issues.

Project risk indicates degree to which sources of finance can accept relatively risky projects. Aid funds are most flexible in accepting somewhat risky projects, while leases must be definite and have minimal risk.

Investor's corporate control indicates to what extent investors demand a large share of control in the venture in which they are investing. For example, strategic investors are least flexible in demands a large share of control.

Some sources of financing demand a high degree of information before financing will be granted. Sources of financing also vary in the degree to which they target particular industry sectors.

Accessibility refers to the ease of the application process to obtain financing, and ability of enterprise to approach a given source of finance. For example, most enterprises can gain access, with a minimum of difficulty in applying, to financing from Russian banks and leasing partners.

Sources of finance also vary in the degree to which they will grant future financing to a company which has already received financing. The cost of different financing options varies as well as indicated on the chart.

Russian Banks are a Common Source of Financing But May Not Match Your Needs

	amount of financing	company size	project risk	investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Russian banks	◕	●	◔	●	medium	medium	●	yes	medium

Russian banks have better knowledge of the local situation than any other source of long term financing; they:

- Speak the language and know the culture, understand the historical and current situation of Russian enterprises
- Understand Russian financial reporting and accounting systems
- Can offer advice on lowering financing costs, based on their experience

On the other hand, Russian banks are extremely risk-averse and will most likely demand substantial collateral. The Russian banking industry is currently in turmoil and many banks are in an unstable situation

Instructor's notes:

Russian banks are easiest to approach and are flexible in the size enterprise they will lend to.

Unfortunately few make loans for a period of more than 18 months.

Foreign Banks: the Russian Enterprise Should Fit into the Bank's Lending Strategy

	amount of financing	company size	project risk	investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Foreign banks	●	◔	○	◕	high	high	◔	yes	medium

- Most foreign banks are particular about the enterprises they will lend to, preferring commodities, utilities/telecoms, and exports
- Some Russian enterprises have obtained finance from foreign banks through subsidiaries registered abroad, but this is difficult to organize and foreign currency regulations are stringent
- The increased presence of foreign banks in Russia has made it more possible to get financing from this source. Those with Russian-licensed subsidiary banks are your best option
- Debt financing from foreign banks may be for a longer time period and at lower cost than from Russian banks. They also have access to large amounts of capital. As most foreign banks with operations in Russia are stable, they often provide a more reliable source of future financing

ofcf4e/Page 6

Instructor's notes:

Note:

A few foreign banks currently operating in Russia are: ING/Barings, ABN-AMRO, Credit Lyonnais, Chase Manhattan, and Citibank.

Foreign banks will expect a professionally organized presentation and are very particular about following the Western way of carrying out business. Therefore, in planning to approach a Western bank you may want to work with a financial consultant experienced in obtaining finance from the type of institution.

Portfolio Investors Provide a Significant Source of Financing for Russian Enterprises

	amount of financing	company size	project risk	investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Private funds	◕	◑	◔	◔	medium	high	◑	maybe	low

Portfolio investors include investment funds (both private funds and "aid" funds), venture capital funds, pension funds, and insurance funds

They are looking for a combination of dividends and capital gains (appreciation in share price)

- investors must provide steady returns to their shareholders
- good management is probably the most important investment criteria

They do not need to have, and usually do not seek, a majority shareholding

- But portfolio investors typically want to have some say in running the business such as:
  - voting at shareholder meetings
  - Board of Directors representation

Instructor's notes:

Although portfolio investors do not wish to take an active part in running the day-to-day business, they may wish to have some voice in major decisions. Because their concerns mostly involve improving their own returns they will be interested in increasing shareholder value (something which should be important to every company director in any case.)

They may be extremely interested in investing alongside a Western strategic investor; and some portfolio investors, especially Western funds, require this

<u>Beware:</u>

There are some "takeover" funds which may be looking to make a quick profit by taking over the management of your company and profiting as soon as possible without regard for the future of the company.

<u>Important Note:</u>

Some provisions of the Joint Stock Company Law of January 1, 1996 will likely make raising funds by private placements of shares (to either portfolio or strategic investors) more difficult. These will be discussed later in the seminar.

There are a Number of Foreign Funds Specializing in the Russia Market

- Stringent SEC regulations prevent US-based funds from investing in most Russian companies
- Less stringent but similar rules (both external regulation and internal requirements of the fund) also make it difficult for European funds to invest in Russia

- Many foreign funds operating in Russia will be investing money earmarked only for Russia or the CIS. This is favorable because then you will only have to compete with other Russian companies for capital
- Because these funds have money which is to be invested only here, the fund will probably have an office in Russia and be familiar with the environment and culture

ofcf4e/Page 8

Instructor's notes:

This slide explains why some of the large US mutual funds are not yet in this market.

If laws in Russia become more favorable, there could be significant inflows of mutual fund and pension fund money.

Some of the funds already present, must invest in Russia because of the provisions of the charter under which they registered the fund. This is good because if Russian companies have to compete with companies in other countries for the same funds, Russian companies may not be very successful, this is due to Russian tax policies and other factors which reduce the competitiveness of Russian firms.

Remember, an investor is most likely to invest money where the return from that investment will be highest at the lowest risk. Does your company or project offer this?

To Deal Successfully with Portfolio Investors, Enterprises Need to Understand their Investment Strategy

Capital scarcity has led many Russian funds to seek immediate trading profit:

- 6 month time horizon
- Will invest only in highly liquid securities (usually large enterprises)

The objective of North American/European portfolio investors is to achieve medium- to long- term capital gains:

- 5 years or greater time horizon
- Will invest in securities of varying liquidity

Size and industry focus of the enterprise are critical factors:

- Portfolio investors seeking trading profits invest in shares of large enterprises
- Large foreign investment funds tend to invest in large enterprises, but the majority of foreign investment funds in Russia are of medium size and are interested in shares of medium size enterprises
- Portfolio investors are increasingly targeting industry sectors

ofcf4e/Page 9

Instructor's notes:

Even when medium term investor will purchase illiquid shares, they will be looking for an exit strategy - either the chance that the shares will become liquid in 3-5 years, or that there will be interest from a new investor (usually a strategic investor) in buying existing shares.

Again, typical industry sectors of interest are:

- oil and gas
- utilities
- metals and metallurgy - service businesses
- food products and processing
- leisure facilities
- telecommunications

<u>Discussion</u>:

Ask the audience to name some portfolio investors of which they are aware or have heard of. Can they give a profile of enterprises they typically invest in?

Multilateral and Bilateral "Aid" Funds Represent A Special Case of Portfolio Investment

	amount of financing	company size	project risk	Investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Aid funds	◑	●	◕	◑	medium	low	◕	maybe	low

"Aid" funds are investments backed by foreign governments:

- Usually consider small investments between $50,000 - $3 m
- Invest in small enterprises: some are dedicated to invest only in small and medium enterprises. They are also a good source for financing a subsidiary business (especially if its a new line of business)
- Welcome unsolicited requests for financing: their doors are open, at least for inquiry
- Are more willing to invest in times of political and economic uncertainty. With the current political environment, there may currently be a much better chance of raising financing from aid-funded sources
- *However*, because they are backed by foreign governments, many political factors enter into their decision-making process which are difficult to predict and impossible to control

ofcf4e/Page 10

Instructor's notes:

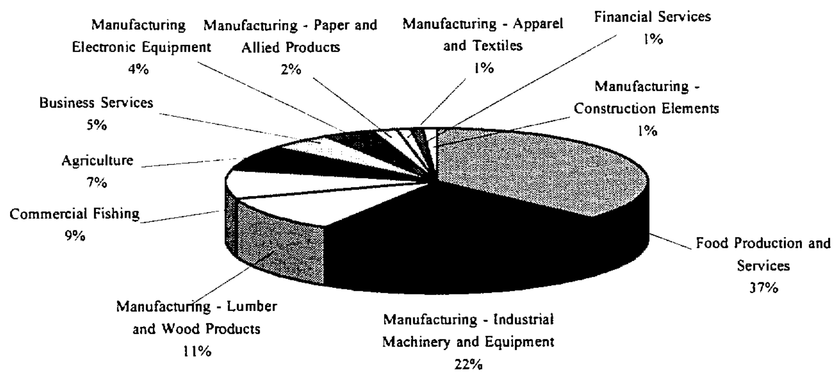
Many aid funds have been established by foreign governments to help small and medium sized businesses. This is necessary because the preparation for financing for a smaller project typically requires just as much preparation as acquiring financing for a large project, therefore most private funds will concentrate on larger projects.

Examples of aid funds are the EBRD regional funds and TUSRIF.

These funds receive many requests and must satisfy strict guidelines for investing, so it is best to be well prepared before making contact.

Aid Funds Tend to Invest Across Diverse Industry Sectors

The US-Russia Investment Fund (TUSRIF) investment breakdown by industry:



ofcf4e/Page 11

Instructor's notes:

__Explain__:

Aid funds often have political mandates to invest in diverse types of business activities. Some have a mandate to invest in projects that for various reasons might not otherwise be funded by commercial sources of finance.

TUSRIF is a well known Aid fund that has been active in Russia for several years.

Note that more than half of the investments are in the industrial manufacturing, food production and services sectors.

If your company is not in one of these sectors it does not mean you have a smaller chance of receiving finance. What this chart shows is the sectors in which attractive projects have been found in the past.

Strategic Investors are Currently the Main Source of Equity Financing in Russia

	amount of financing	company size	project risk	Investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Strategic investors	●	◑	◑	○	high	medium	◔	yes	low

Strategic investors may be:

- Companies in the same or related industry looking to expand current lines of business
- Companies in an unrelated industry trying to make better use of their assets
- Financial-industrial groups (FIGs) which are trying to develop strategic relationships - however, joining a FIG doesn't guarantee financing
- Able to provide a range of valuable contributions in addition to financing
- Likely to place a higher value on an enterprise's shares than would a portfolio investor
- Seeking a long term relationship, and significant authority over operating decisions (often majority interest, at a minimum a seat on the board of directors).
- May require unpopular measures relating to restructuring and strategic change

Instructor's notes:

Explain:

Strategic investors typically have knowledge, contacts, and other synergies to offer that can improve your business and their own simultaneously. Consequently, they may be willing to pay more than portfolio investors would for shares of your enterprise. For similar reasons, they might be more willing to invest in a risky project.

Strategic investors want control. They will prefer to take a majority interest in a Russian enterprise (many won't consider less than a 51% shareholding, and some prefer to have over 75% in order to have full control), and may want veto power over some major decisions. At a minimum they will want a seat on the Board of Directors.

Why Might Strategic Investors be Interested in Your Company?

Strategic investors often want to establish distribution channels in Russian/CIS/Eastern European markets and look for:

- Well-established market share or specific market share rights
- Low-cost production
- Sources of highly qualified and relatively inexpensive labor
- Technology
- Synergy with operations in other countries
- Potential economies of scale
- Opportunity to sell products in Russia (if supplier)
- Ready sources of raw materials (if customer)

Medium-sized enterprises offer the best opportunity for strategic investors to achieve their business objectives, especially if the amount of investment allows the investor to significantly influence operating decisions

ofcf4e/Page 13

Instructor's notes:

Many large enterprises have set up subsidiary joint ventures with foreign trade partners because the partner had interest in only a part of the company's activities. (e.g. Uralmash formed a joint venture subsidiary, UNOC, together with National Oilwell and Caterpillar, for the production of oil rigs.)

Some strategic investors may be interested only in very large enterprises, because these offer leverage, visibility and reduced risk exposure thanks to the interest the local authorities will have in the enterprise's welfare.

Remember, your company has something to offer to a strategic investor, and what you offer is what interests them. So in developing a project proposal to present to a strategic investor, emphasize everything your company can offer in very specific terms. For example:

- •detailed description of production equipment
- •43 current customers which purchase XXX from us
- •rights to 400 hectares of forested land

It must also be noted that there are some unscrupulous potential "strategic" investors who are not interested in the long term future of the enterprise, but rather in short term control over product flow. For example, some metal traders who have taken equity stakes in their trading partners in order to ensure supply (sometimes to the detriment of the company's profitability).

Examples of Strategic Investment Projects in Russia

Investment	*Strategy*
General Electric and Rybinsk Motors plan to set up a joint venture to produce aircraft and industrial engines	• Access to technology • Source of supply
RJR has made majority investments in several cigarette manufacturers in the CIS	• Low cost production • Distribution in the CIS
ABB has set up 16 joint ventures with Russian enterprises	• Sources of local supply • Low cost production • Distribution in Russia
Caterpillar, National Oilwell, and Uralmash have set up a joint venture to produce oil rigs	• Distribution in the CIS • Low cost production

ofcf4e/Page 14

Instructor's notes:

Additional Benefits Offerred by a Strategic Investor

- New technology, unique equipment
- Market and industry knowledge
- Distribution access in foreign markets
- Expansion of product range
- Market recognition of investor's brand name, reputation
- Potential economies of scale in purchasing, production and distribution
- Joint production synergy
- Supplies (if investor is a supplier) or a ready market (if investor is a customer)
- Training and access to experienced professionals
- Typically offers higher value on equity share than a portfolio investor
  - knows business better, so can better assess share value
  - can add value to business besides just capital
  - synergy between the 2 businesses may increase the value to the strategic investor
- Follow-on financing

ofcf4e/Page 15

Instructor's notes:

Establishing a Subsidiary Joint Venture with a Strategic Partner Offers Several Benefits

Benefits to Outside Investors:

- Clearly defined
- Separate legal entity
- No liabilities for social assets, etc.
- Tax breaks
- Allows the investor to start small and get to know the enterprise before investing in the enterprise itself
- Opportunity to control and to install new management

Benefits to the Russian enterprise:

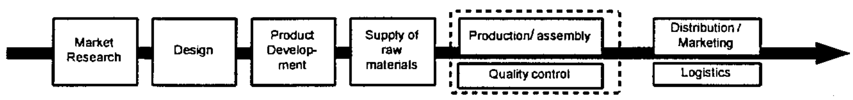
- Can offer examples of western management practices that can be transferred to the main enterprise
- Can give the western partner what it wants (management control, majority ownership) without ceding control of the main plant
- Can allow the enterprise to prove itself as a responsible partner for future investment (lowering future cost of capital by reducing perceived risks)

ofcf4e/Page 16

Instructor's notes:

Without Local Marketing Expertise, Strategic Investors Will Typically Supply Design and Development Know How, and Quality Control

Involvement of both partners in the value chain



	Market Research	Design	Product Development	Supply	Production/ assembly	Quality control	Distribution/ marketing	Logistics
Investment / Joint Venture	○	○	◍	●	●	◍	○	●
Industrial Cooperation	○	○	●	●	●	◍	○	●
Sub-contracting	○	○	○	● ○	● ○	◍	○	◍

○ Fulfilled by Western partner
◍ Fulfilled by Eastern partner under Western control
● Fulfilled by Eastern partner with Western assistance
● Fulfilled by Eastern partner without Western assistance

Source : Interviews

ofcf4e/Page 17

Instructor's notes:

Note that the Western strategic investor will typically demand a larger degree of control over operations when they make a large investment, such as in a joint venture where the investor has taken a large share of equity.

In industrial cooperation, where the investment is less substantial, usually in-kind contribution, the Western partner is less directly involved in the everyday operations.

Finally, subcontracting tends to be more of an arms-length transaction, with the Western investor primarily interested in receiving goods produced using the Russian partner's existing capabilities, although there may be a contribution in materials or even in equipment on some occasions.

119

There are Several Other Options for Long-Term Financing Which are Possible, but not Frequently Used in Russia Today

The options for long term financing can be divided into:

- Currently used sources of long-term financing
  - Russian banks
  - Foreign banks
  - Portfolio investors - private funds
  - Portfolio investors - "aid" funds
  - Strategic investors

- **Other less frequent but up-and-coming sources of long-term financing**
  - **Public issues of shares/rights (Russian and foreign, including ADR/GDRs)**
  - **Bonds**
  - **Convertible bonds**
  - **Leasing**

ofcf4e/Page 18

Instructor's notes:

Discussion:

Before continuing ask: Which of the types of financing we've covered so far are the most attractive? Why?

Now we are entering a section on less frequently used financing instruments.

Emphasize:

These sources will not be appropriate for every company but are expected to become more common in the near term. The prepared general director and financial director should know about them.

1 118

The Decision to Undertake a Public Issue Depends on Market Conditions

	amount of financing	company size	project risk	Investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Public issues	◑	◔	◔	◕	high	medium	◔	no	medium

A Russian enterprise can consider a public share/rights issue either in the Russian market or in a foreign market.

- Combining funds from a variety of sources may allow the enterprise to raise more money
- It results in a diversified shareholder base with no major holding by one investor
- Increases liquidity of share trading, allows market valuation on shares
- Excellent publicity for the enterprise <u>if successful</u>
- Expensive: preparation, issuing costs, advertising costs, etc.
- Uncertain beforehand how much money will be raised unless all the issue is pre-placed with one or a few buyers
- With a rights issue, the purchaser receives the right to purchase new shares, rather than the actual shares themselves. New legislation has just created this option, but no rights issues have yet taken place in Russia.

ofcf4e/Page 19

Instructor's notes:

<u>Emphasize:</u>

Unless your company is already well-known the expense of this type of financing may not yet be reasonable.

> <u>Question:</u> Who would purchase the shares of a company they've never heard of to provide financing for a product they've never seen?
>
> Answer: Only a gambler? But most gamblers have found casinos much more convenient than new stock issues.

If your company is well-known and respected, or your product is well-known then this type of financing is more appropriate

The Russian market is not currently favorable for new share issues, largely because of economic and political uncertainty. This has improved slightly since the presidential elections, but greater improvement is expected only in the medium term.

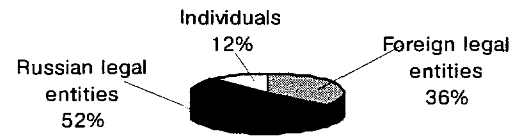
The Joint Stock Company Law of January 1, 1996 established preemptive rights for existing shareholders. This means that existing shareholders have the right to purchase any new shares in proportion to their current holdings. The differences between share issues and rights issues will be discussed in more detail later.

Public Issues in the Russian Market: Who Buys the Shares?

- A public issue in Russia includes sale of shares/rights to foreign investors investing in Russia
- Russian individuals currently buy a very small percentage of publicly offered shares
- Most shares are sold to Russian and foreign portfolio investors, although a significant portion may be presold - either to portfolio investors or to strategic investors

Example of Purchaser's Composition for a Public Share Offering

Red October Share Distribution



ofcf4e/Page 20

Instructor's notes:

Emphasize:

Stock is a share of the ownership of a company, and public companies must be responsive to their shareholders or owners.

Note the differences in management: For a one owner company, or for a small group of owners, or for hundreds or thousands of owners.

A one owner company: Basically a dictatorship

A small group: A committee that makes decisions

Hundreds of owners: Most don't understand the business, most are interested only in acquiring return on their investment in the company. The owners pass responsibility to a Board of Directors.

Russian Enterprises Have yet to Raise Money Through a Public Issue in Overseas Markets

Public issues in a foreign market provide access to international capital, valuation of shares, and excellent publicity for the enterprise if successful. Unfortunately, they are even more expensive than a public issue in the Russian market and are an option only for large, well-known Russian enterprises.

Direct share issues: A combination of securities law and market forces prevent Russian enterprises from raising money through direct share issues in most foreign markets

ADR/GDRs (American Depository Receipts / Global Depository Receipts):

- Mosenergo and LukOil have arranged ADR issues; others have arranged GDR issues - but these issues are based on resale of shares already on the market and have not raised financing
- Seversky Pipe Works has received permission to issue ADRs; ten other Russian companies have filed necessary documents

Why arrange ADR/GDR issues if no funds are raised?

- Long term strategy - Russian companies are arranging ADR issues now to get their names known in foreign markets and to create a market for their shares
- This is good preparation for a future ADR issue

ofcf4e/Page 21

Instructor's notes:

Emphasize

Only large issues are worth the expense and trouble of an ADR issue - minimum $20 m; most ADR issues are over $100 m

Only the largest and most well-known companies can issue ADR's. There is tremendous cost in underwriting and filing fees which means this type of financing will be economical only if the issue is very large (i.e. $100 million).

ADRs and GDRs stand for American Depository Receipts and Global Depository Receipts, respectively. These are rights to shares which are traded in markets where the shares themselves would be unable to trade, because they would not meet stringent securities commission requirements. Issues of depository receipts are quite complicated, and any enterprise undertaking this process must have the assistance of professional and legal advisors.

Bond Issues are Also Currently an Option Only for Large Russian Enterprises

	amount of financing	company size	project risk	Investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Bond issues	◔	○	○	◕	high	high	○	no	high

Bonds are investment instruments which differ from equity in that they:

- Usually have fixed interest payments made in regular intervals
- Usually have a fixed lifetime
- Require a set principle payment on redemption
- Hold a priority claim on assets in case of default

Bond issues are extremely rare in Russia and very expensive - high interest payments are required to cover investors' risks

ofcf4e/Page 22

Instructor's notes:

Explain:

Typically Corporate Bonds are issued by:

- Public Utilities (Electric Companies)
- Transportation Services (Airlines, Railroads, Road Authorities)
- Large Industrial Companies (GAZ, LukOil)
- Banks and Finance Companies

Exercise:

Describe the difference between bonds and shares.

Answer: The difference is that bonds are loans which must be repaid, whereas shares represent ownership in the enterprise.

How Enterprise Bonds Work

- Bonds are frequently issued in North America in denominations of $1,000, referred to as the "face value" or "par value" of the bond
- Bonds may be secured, representing a pledge on some sort of collateral, or unsecured, where the riskiness of the bond is solely dependent on the financial strength of the issuer
- Most bonds pay a specified interest rate ("coupon rate"), stated as a percentage of the face value; some are zero-interest, and some have floating interest rates
- The stated interest rate of the bond may or may not equal the prevailing market interest rate on securities of similar risk. In the case that the stated interest rate is greater than the market interest rate, the bond will sell at a premium over its $1,000 face value, if less than the market interest rate at a discount to its face value. The overall return on the bond based on its purchase price is known as its "effective interest rate" or "yield"
- Enterprises which would like to issue bonds will attempt to do so in an economic climate with relatively low interest rates

ofcf4e/Page 23

Instructor's notes:

Who Buys Bonds and What Risks do They Experience?

BUYERS	***RISKS***
• Portfolio buyers who need regular income and portfolio diversification • Pension funds and institutional investors • Banks and finance companies • Insurance companies • Other corporations with excess cash - may be short- or long-term • Private investors • Foreign governments, especially government issued bonds • Strategic investors looking for unique investment tools • Governments, as a means to subsidize certain industries or companies	• Interest Rate Risks - The value of the bond may change significantly with changes in interest rates • Purchasing Power Risk (Inflation) - If inflation increases, coupon payments may not adequately compensate the investor (if not variable rate bonds) • Market Risk - In Russia, there is no easily accessible primary market for bonds • Liquidity Risk - there is no secondary market for bonds • Credit (Business) Risk - The risk of default is high for many companies due to economic uncertainties • Issue Specific Risks - Lack of well defined legal framework to protect investors

ofcf4e/Page 24

Instructor's notes:

Interest Rate Risk

1. It affects the prices of fixed income securities since bond prices move inversely with interest rates.

2 .It affects the income generated by fixed income securities via its impact on the reinvestment rate and, hence, the interest on the coupon interest.

Each factor acts in opposite though not necessarily equal directions.

Purchasing power risk: The coupon and principle repayment schedules of fixed income securities usually offer no indication to inflation

Market Risk: This is related to interest rate risk since the after market for bonds tends to be driven by changes in the interest rates (falling-active, rising-stagnant)

Issue Specific:

1. Call Risk -a company bought a bond at higher than face value (due to interest rate fluctuations) and the issuer calls it causing a loss to the purchaser.

2. Lack of legal infrastructure to protect investors severely limits this type of financing.

Liquidity Risk: The risk faced by investors that they will be unable to sell the financial instrument (in this case, the bond) and receive cash.

Bond Issues Might be Possible in the Future, But are Difficult to Arrange

Working with an experienced consulting firm or investment bank is essential

- Complex laws and requirements that most companies don't have time to master
- Difficulties in preparing materials necessary for presentation to regulators and investors

May be most appropriate as a means to complete negotiations with strategic investor

- Some features of bonds (such as conversion) may satisfy the requirements of both sides to get negotiators back to the bargaining table to complete an otherwise lost project
- Investor may be given the opportunity to convert bonds into a controlling interest under certain circumstances

Easier if the bond issue can be secured with inflation resistant assets

- Oil and gold reserves will help
- Readily marketable machinery or equipment are common

Offering floating rate bonds can protect the issuer and the holder

- The rate of interest paid out on floating rate bonds may be changed during the term of the bonds
- Given the high inflation and interest rates prevailing in Russia, bond issuers may want protection from excessive interest payments in the event that economic stability comes
- In the West, bond interest rates are sometimes tied to certain economic indexes to project against economic uncertainty

ofcf4e/Page 25

Instructor's notes:

Note that like an issuance of new stock, a bond issuance is very complex and companies should seek experienced advisors / underwriters before undertaking to obtain this type of financing.

Only a few Russian enterprises have issued bonds, but this may become a more widespread option for raising financing in the near future.

Convertible Bonds Lie Between a Bond and a Share

	amount of financing	company size	project risk	Investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Convertible bonds	◑	◔	◔	◑	high	medium	○	no	medium

- Convertible bonds provide for conversion into some other security, usually common shares of the issuer (50 or more is common), at the option of the bondholder
- The bondholder is thus able to convert the claim into an ownership interest if company operations prove successful and conversion becomes attractive; in the meantime, the special rights of a creditor are maintained
- Bonds may also be redeemable in terms of commodities, such as oil or precious metals

ofcf4e/Page 26

Instructor's notes:

Convertible bonds are very popular for young "start-up" companies and high-tech companies in the US. When convertible bonds start appearing in Russia, conversely, large companies will most likely have the most luck until these instruments become more widespread.

They are a cheap source of financing which can provide the investor with a profitable equity share in the company if it does well.

Advantages of Convertible Bonds

- A type of equity issue which only dilutes earnings per share and voting/ control rights if and when converted
  - if stock value doesn't increase a holder may choose redemption without conversion
- Holders enjoy current income plus the opportunity to participate in equity gains
- The conversion feature makes the bond more valuable, enabling the issuer to pay a lower interest rate (or sell at greater premium or less discounted) than would be the case of a straight bond
- Coupon payments are typically tax deductible, unlike dividends
- Several Russian enterprises are currently considering this option

ofcf4e/Page 27

Instructor's notes:

This type of option in Russia may be what is necessary to allow bond financing to prosper and gain widespread acceptance. Nevertheless, the management of each company will have to be prepared to accept a dilution of control of their company.

Leasing Is a Viable Alternative to Purchasing

	amount of financing	company size	project risk	Investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Leasing	◔	●	○	●	low	low	●	yes	low

- A lease is a contract specifying the terms under which the owner of a property, the lessor, transfers the right to use the property to a lessee
- Business enterprises may lease land, buildings, and almost any type of equipment
- Some leases are simple rental agreements ("operating leases"), while others closely resemble a debt-financed purchase of property ("capital leases")
- Due to certain tax provisions, leasing can be an economically beneficial option for both lessee and lessor, and is used by some lessees despite the fact that they have the funds to purchase the asset leased

ofcf4e/Page 28

Instructor's notes:

<u>Emphasize</u>:

Under the lease agreement the lessor retains the right of ownership over the leased assets. This serves as a guarantee against default of payment. Additionally, payment default can be insured separately and costs are passed on the lessee.

As for tax advantages, the lessor's profit tax gets credited over the term of the lease and becomes payable when each lease payment falls due. Conversely, upon a genuine sale of an asset the seller must pay profit tax in full.

Advantages of Leasing

Advantages to lessee:

- Avoids risks of ownership - including casualty loss, changing economic conditions, physical deterioration, and obsolescence - this makes lease financing popular for high technology assets such as computers and medical equipment
- Lessee can match cash outflows to inflows resulting in reduced financing needs; lease payments can be tailored to the lessee's cash flow - less now, more later, or vice versa
- Lease payments are typically tax deductible for profit's tax and property tax
- Many western equipment suppliers are anxious to enter the Russian market and may offer especially attractive terms

Advantages to lessor:

- Increased sales - a manufacturer or dealer may significantly increase its sales volume by offering potential customers (who are unable to purchase) the option of leasing its products
- Tax benefits - lease agreements can specify who assumes benefits/liabilities
- Ongoing business relationship with lessee
- Residual value retained - the lessor may lease the asset to another lessee or sell the property and realize and immediate gain

ofcf4e/Page 29

Instructor's notes:

The drawback of leasing transactions is the fact that legislation in this area is scarce. At present the bill of leasing law is being considered by the Ministry of Finance of Russia.

Contractual Provisions of Leases

The most important provisions are as follows:

- ***Cancellation provisions*** - provisions for and penalties incurred when the lease is canceled by the lessee. "Non-cancelable" refers to those lease contracts whose cancellation provisions and penalties are so costly that in all likelihood, cancellation will not occur
- ***Lease term*** - the time period from the beginning to the end of the lease. The end of the lease term is the end of the fixed non-cancelable period of the lease plus any periods covered by attractive renewal options which would strongly indicate that the lease will be renewed
- ***Purchase option*** - a right for the lessee to purchase the leased property at some future date. A definite purchase price may be specified, or some relation to fair market value of the property at the time of the option may be specified
- ***Residual value*** - some lease agreements require the lessee, or a designated third party, to guarantee a minimum residual value. If the market value at the end of the lease term falls below the guaranteed residual value, the lessee or third party must pay the difference

ofcf4e/Page 30

Instructor's notes:

__Discussion:__

Ask the audience if they understand leasing and why it may be the preferable way to finance equipment purchases. Ask if any have considered leasing equipment.

In Choosing the Appropriate Source of Long-Term Financing, Start by Considering the Critical Issues

Ask yourself the following questions . . .

How much financing is needed?	How large is the legal entity receiving the funds?	How much control are you willing to give up?	How risky is your project?
What sources typically finance projects of this size?	What sources typically finance companies of this size?	Which sources will be interested in exerting control over operations?	What sources are the least risk averse?

ofcf4e/Page 31

Instructor's notes:

[Each of these "criteria for selecting appropriate sources of short term finance will be explained separately, in the next four slides.]

Choosing the Appropriate Source of Long-Term Financing

. . . and use the chart to help find the answers

	amount of financing	company size	project risk	Investor's corporate control	info. required	industry specific	access-ibility	future financing	cost
Russian banks	◕	●	◔	●	medium	medium	●	yes	medium
Foreign banks	●	◔	○	◕	high	high	◔	yes	medium
Private funds	◕	◑	◔	◔	medium	high	◑	maybe	low
Aid funds	◑	●	◕	◑	medium	low	◕	maybe	low
Strategic investors	●	◑	◑	○	high	medium	◔	yes	low
Public issues	◑	◔	◔	◕	high	medium	◔	no	medium
Bond issues	◔	○	○	◕	high	high	○	no	high
Convertible bonds	◑	◔	◔	◑	high	medium	○	no	medium
Leasing	◔	●	○	●	low	low	●	yes	low

ofcf4e/Page 32

Instructor's notes:

132

How Much Money You Need Limits the Sources of Financing you May Consider

How much financing is needed?

- For only large amounts, look to foreign banks, strategic investors, public issues, bonds, and convertible bonds
- For both large and small amounts, look to Russian banks, private investment funds (depends on the fund), "aid" funds, and leasing

ofcf4e/Page 33

Instructor's notes:

It may sound surprising, but currently in Russia, it may be easier to get funds for a large project than for a small one. The amount of time and effort to understand Russian financial information and to assess risks associated with project is the same no matter what the project size: therefore many sources wish to concentrate on larger ones which justify the "entry cost".

Different Sources Have Wide Target Ranges of Financing They Offer

Approximate ranges of financing offered:

• Russian banks:	\$20,000 - \$30 m
• Foreign banks:	\$500,000 -\$100 m
• Private investment funds:	\$500,000 -\$100 m
• "Aid" funds:	\$25,000 -\$100 m
• Strategic investors:	\$10 m - \$200 m
• Public share issues:	\$10 m - \$300 m
• Public bond issues:	\$50 m - \$300 m
• Public convertible bond issues:	\$30 m - \$300 m
• Private placements of bonds:	\$5 m - \$100 m
• Leasing:	\$10,000 - \$20 m

ofcf4e/Page 34

Instructor's notes:

Explain:

These are very approximate ranges based on the experience of the consultants. An individual company's experience may be different.

Note:

When looking at the range shown for Russian banks, it is necessary to consider regional banks and large Moscow banks separately. Find out what the maximum lending rate is for banks in your region.

Aid funds have different political agendas, and the range indicated is not the range for all funds. The higher end of this range, in particular, only applies to the big international lending organizations, such as the EBRD and the IFC.

The range shown for strategic investors is the range Russian enterprises should generally keep in mind when considering contacting a potential strategic investor for financing. There are many cases, however, of strategic investors approaching Russian enterprises and offering to make smaller investments in order to establish a trading relationship with the Russian enterprise.

The Size of the Company Determines the Source of Financing

How large is the legal entity receiving the funds?

Four issues to consider:

1) Larger companies tend to have larger projects
2) Some sources of financing require that the company be well-known (public issues, bond issues, convertible bond issues)
3) Shares of larger enterprises tend to be more liquid; this is a concern for some sources of financing (portfolio investors - private funds)
4) Some aid funds, conversely, have a mandate to invest in small to medium sized enterprises

ofcf4e/Page 35

Instructor's notes:

If your enterprise is medium to large size and you wish to be able to pursue financing from some of the aid funds concentrating on smaller size companies, you may consider establishing a smaller subsidiary to receive the investment; this will be especially attractive if the project involves a new line of business.

Different Types of Collateral are Required by Different Sources of Short-Term Financing

How much control are you willing to give up?

- Strategic investors will wish to exert control over operating and other decisions
- Private funds and aid funds may wish to have board of directors representation
- Foreign banks may have strict loan covenants
- Russian banks are less interested in control
- Public issues of equity, bonds, etc. will diversify shareholder base discouraging any one shareholder having a large interest

Most Russian enterprises have limited options for financing without giving up some control

ofcf4e/Page 36

Instructor's notes:

<u>Emphasize</u>:

The most likely current source of long term financing for most Russian enterprises is equity investment in the enterprise, either from portfolio investors (private funds or aid funds) or from strategic investors. This investment, by definition, will dilute control of the enterprise.

If management is dead set against giving up any control, options of financing will be severely limited. It is worth considering the question then of what management (or the leading shareholder) wishes to retain control of, if the business will be unable to meet or beat its competition without investing in strategic projects funded with additional external financing.

Is it worth retaining control of a dying business?

The Riskiness of the Project Narrows the Range of Potential Sources of Financing

How risky is your project?

- Aid funds, with political motivations for investing in diverse projects in Russia, are more likely to consider risky investments
- Strategic investors, with business skills and contacts to offer which can reduce the risks of particular projects, may also consider financing projects other sources won't consider or for which they will require an extraordinary high rate of return to finance
- Russian banks are extremely risk averse, but understand Russian political and country risk
- Foreign banks are likely to be the most risk averse source of long term financing

ofcf4e/Page 37

Instructor's notes:

Re-emphasize:

The higher the riskiness of the project, the more expensive financing will be.

Any way of reducing the risk of a project will increase its attractiveness to potential lenders/investors, and lower the cost of financing, whether it be the interest rate from a bank or the percentage ownership required from an equity investor for a given investment amount.

As with Short-Term financing, Identify Appropriate Sources of Finance Ranking them in Terms of Cost

Step 1:	Consider the most important issues: How much financing is required? How large is the company? How much control are you willing to give up? How risky is your project?	Project: new equipment purchase Amount: US$ 400,000 Co. size: medium Control: low Risk: low
Step 2:	List potential sources of finance for your project.	Bank finance, private funds, aid funds, leasing
Step 3:	Rank them in order from least expensive to most expensive.	1. Leasing 2. Aid funds 3. Private funds 4. Bank finance
Step 4:	Begin by pursuing the least expensive source of finance and work down the list. You may have to obtain financing from several sources.	1. Leasing 2. Aid funds 3. Private funds 4. Bank finance

ofcf4e/Page 38

Instructor's notes:

Emphasize:

Financing from several sources may be required for a single project, either because of the size of its requirements, or because of the nature of its components, or because of complexity.

Exercise 4.1: Choosing Appropriate Sources of Financing

Your medium sized company produces consumer goods for the Russian market and is moderately profitable. You wish to invest $15 m to modernize your existing machinery, which will have two main benefits:

1) cost reduction

2) improvement of product quality

Modernization will take 18 months

You might consider giving an investor a seat on the Board of Directors

What sources of financing should you consider?

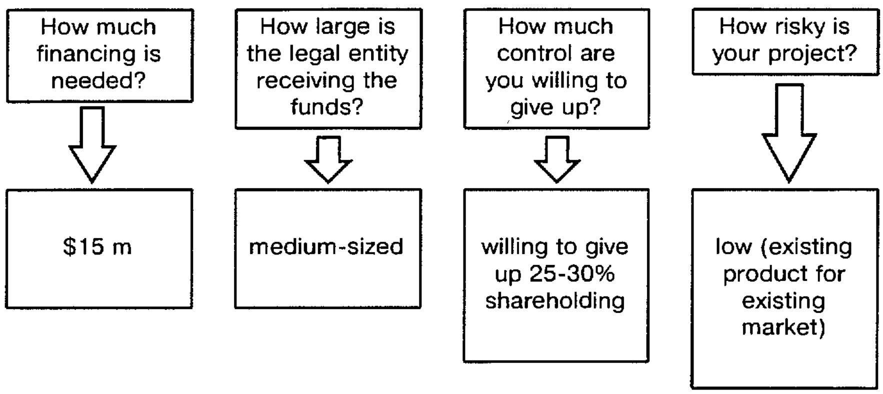
ofcf4e/Page 39

Instructor's notes:

Give the participants a few minutes to reflect on the information, then proceed to the following slide, where the key issues are considered.

Exercise 4.1: Choosing Appropriate Sources of Financing (continued)

Ask yourself:



ofcf4e/Page 40

Instructor's notes:

Re-emphasize:

These are the key questions to consider when thinking about alternatives for long term financing.

Discussion:

Ask the participants what would be the appropriate sources of financing to consider. Ask other participants if they agree. Try to get a discussion going.

Exercise 4.1: Choosing Appropriate Sources of Financing (continued)

Potential sources of finance:

Russian banks - won=t generally give loans for 18 months

Foreign banks - you are not in an industry they target, you do not export

✓ *Private funds - possible, but only from those who are interested in your industry*

✓ *"Aid" funds*

✓ *Strategic investor - your local distribution system would probably be of interest to them, but they might want more than a 30% shareholding*

✓ *Public issues - possible, but difficult - your company is probably not well enough known to do a successful public issue in the current market*

Bond issues - your company would need to be even better known to do a bond issue in this market

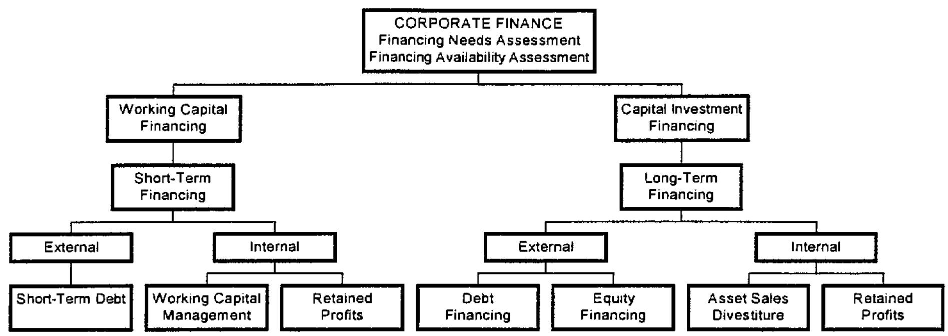
Leasing - you are not acquiring equipment

ofcf4e/Page 41

Instructor's notes:

Go through the options that some participants named which are not checked and explain why they are not appropriate.

What Happens Next?



In the following section we will discuss how to prepare for, approach, and negotiate with the most likely sources of long term finance

ofcf4e/Page 42

Instructor's notes:

<u>Explain:</u>

In this section, we have looked at sources of long term financing.

In the following section we will discuss how to prepare for, approach, and negotiate with the most likely sources of long term finance.

Seminar Agenda

Session 1:	Finance Overview
Session 2:	Project Selection
Session 3:	Sources of Short-Term Finance
Session 4:	Sources of Long-Term Finance
Session 5:	**Preparation, Approach, Negotiations**
Session 6:	Specifics of a Business Plan, Investment Memorandum and Issue Prospectus
Session 7:	Company Valuation
Session 8:	Summary

ofcf5e/Page 1

Instructor's notes:

This section will discuss the alternative approaches in getting finance for the company and will give practical advice on how to approach investors and lenders. It names the steps necessary for the communication with bankers and investors, explains how to structure the communications with them and emphasizes negotiating points to keep in mind.

This Section will Focus on What is the Right Approach to Potential Lenders and Investors

1. *General preparation and approach to sources of external financing*

2. *Specific preparation for, approach to and negotiations with different sources*

Banks

For short and long term financing

Portfolio investors

For long term financing

Strategic investors

For long term financing

Public share/rights issues

For long term financing

ofcf5e/Page 2

Instructor's notes:

Explain:

The most likely sources for external financing are listed here.

Some of these options may be undertaken simultaneously (bank financing and strategic investor search, for example), but some are mutually exclusive (a public share issue and a strategic investor search, for example).

Note:

We do not discuss Russian government sources of finance, which might be quite beneficial in some cases. Because negotiations with these sources are primarily political, they are not covered in this seminar.

We will begin by discussing general preparation which is necessary regardless of the source of external financing pursued, then we will discuss specifics of preparation, approach, and negotiations with each different source of funds.

Your Project is But One of Many

- *Everywhere in the country and in the world, funding sources are scarce, so sources of funds will choose the most profitable projects after considering all risk factors*
- *You must be better and smarter than your competitors to receive funds*
- *If you fail at any single stage of the negotiations with investors/ lenders, the whole process may have to be repeated, so each stage is equally important*
- *If you've done everything right and don't get financing, your project may not have been the right idea in the first place*

Even assuming that your project is intrinsically good, you must maximize your chances to obtain financing for it

ofcf5e/Page 3

Instructor's notes:

Stress that financial resources are extremely scarce currently in Russia, so apart from the common truth that higher risk (that is the case with many current Russian projects) has to be compensated by higher returns, there is competition for desperately scarce funds.

Critically Examine Your Project and Enterprise the Way a Potential Lender/Investor Will

A potential lender/investor:

- Wants to hear about realistic projects that make strategic sense
- Wants to hear the "right" things:
  - "We've been working with an international audit firm"
  - "We are installing new financial control software"
  - "We have an independent registrar"
- Wants to talk with managers who have a realistic idea of the cost of financing in Russia
  - All long term finance in Russia is expensive
  - The most likely source is equity finance from either portfolio or strategic investors, which probably means giving up significant ownership of the enterprise and possibly control
    - At the least it means giving up the autonomy the company may presently enjoy

If you are not prepared to face the realities of obtaining finance, don't waste your time trying to get it

ofcf5e/Page 4

Instructor's notes:

Some "wrong" things to say:

- "We want to enter a new market with a new product" (without a very good reason and without a well thought out strategy)

- "We want to maintain the extent and quality of social assets"

- "We want to maintain a certain level of employment"

Cost of equity finance:

Most investors in the Russian market are looking for undervalued businesses/assets with turnaround potential, offering significant rates of return (35% or more) to justify the risks involved. They want some control over their investment in order to reduce their risk.

What Risks Will Demand A Higher Rate of Return?

Specific risks apply to investment in enterprises in Russia, including but not limited to:

- Political and economic risks
- Currency and repatriation risks
- Undeveloped system of civil and corporate law
- Lack of insurance
- Standards of reporting and disclosure
  - Accounts do not present a "true and fair view" of an enterprise
  - Poor audit standards
  - Onerous and uncertain taxation
- Securities market risk
  - Illiquidity
  - Volatility of share prices
  - Lack of clearing and settlement systems
  - Uncertain share registration
- Management and corporate governance
- Environmental risks

ofcf5e/Page 5

Instructor's notes:

Examples:

Insurance - After a fire destroyed practically the entire engine plant at KamAZ, potential American investor KKR insisted that the enterprise take out insurance on all major production facilities.

Share registration - British investor Transworld Metals showed up to attend the annual shareholder meeting of Krasnoyarsk Aluminum, to find its name had been wiped off the shareholder register, and it no longer had claim to its shares.

Taxation - An international oil company invested in Russia with agreements in place for certain tax treatment; these agreements have been declared void, and certain taxes have been applied retroactively.

Discussion:

Ask the audience for other examples they know of.

How Can Management Reduce the Risks?

Risk	Measure
Undeveloped system of civil and corporate law	• Specify in all contracts the method and terms of arbitration, preferably outside the court system
Lack of insurance	• Take out insurance on buildings and production facilities
Standards of reporting and disclosure - Accounts do not present a "true and fair view" of an enterprise - Poor audit standards	• Install new financial and management accounting systems • Contract an internationally respected audit firm
Securities market risk - Illiquidity - Uncertain share registration	• Make every effort to have shares listed on one or more exchanges/trading systems • Contract an independent registrar
Management and corporate governance	• Distribute financial and other information yearly, preferably quarterly, to shareholders, comply with all regulations of the Federal Commission on Securities and Stock Markets, ensure rights of minority shareholders

ofcf5e/Page 6

Instructor's notes:

While enterprise managers can do little about political and economic risks in Russia, there are some risks they can take measures to reduce to make investment in their enterprises more attractive.

Discussion:

Do the participants have additional ideas?

How to Match Your Enterprise with the "Right" Lendor/Investor

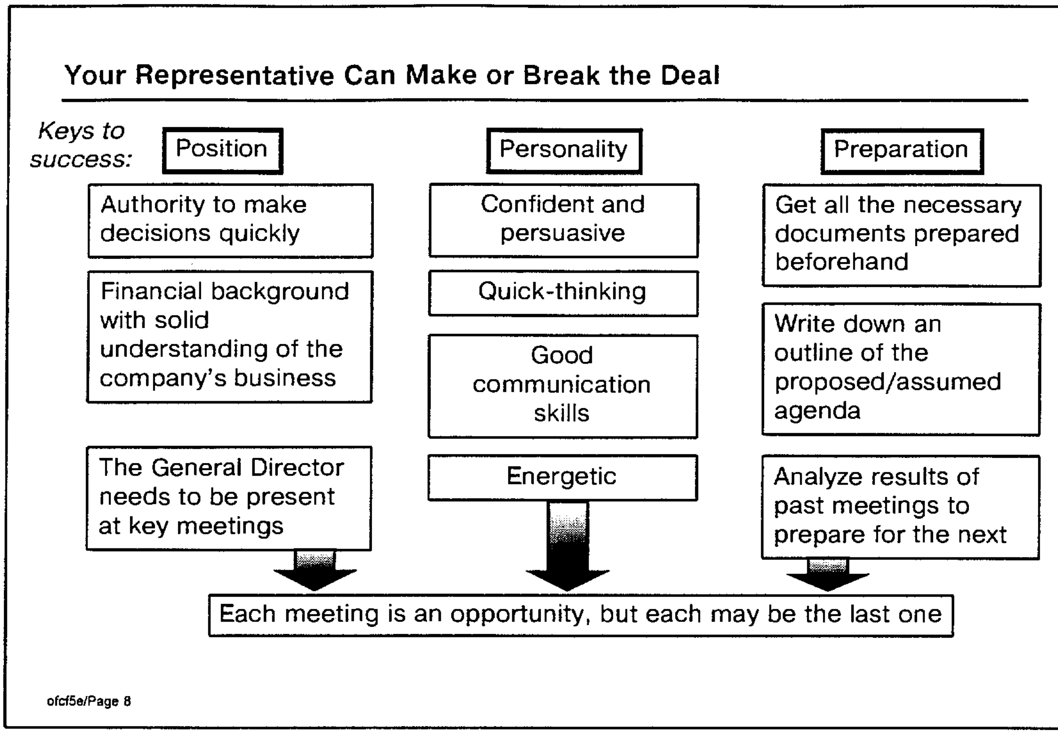
Investor/Lender's Position	Borrower/Investee's Reaction
They don't have time to waste in negotiations	The representative must have the authority to take decisions
Investment means risk, so they need information to minimize the risk	Information must be readily available and delegated to one department
They want to get the maximum return from their investment	You have to negotiate the interest rates for loans, ownership percentage for investment
They already have an 'ideal borrower/investee' image	You must try to fit the image; change your position, not the investor's standards
They spend a lot of time and effort in analyzing companies' performance	You must learn the investors/lenders criteria and find out their decision factors
They often have previous experience of long-term relationships with companies	Don't attempt to cheat; reputation is more valuable than any single project

Try to be the ideal candidate to meet investor/lender requirements

ofcf5e/Page 7

Instructor's notes:

Stress that the search for a good investment project is a task that is performed both by the companies seeking investment and the investor searching to profitably invest in companies. Therefore, try to concentrate on fitting the image of an 'ideal' investee better than your competitors.



Instructor's notes:

<u>Stress</u>:

It is quite difficult to find a person of this type within the company, the choice is genuinely limited to the few top managers of the company. The top manager chosen must have delegation of power from the general director, and call upon the general director to personally attend critical meetings if he judges it necessary. The top manager in charge of negotiations must continuously inform the executive committee of the progress made and problems encountered.

Potential Investors/Lenders Might be Negatively Influenced if Your Representative Does Not Have Company Details Readily Availbale

Sales data for the last year or two

Broken down by month or quarter and by product line

Including division between cash and barter sales, domestic and foreign sales

Product description

- Types and models of products, capacity utilization
- Production volumes of each, accompanying sales data for each, accompanying cost data

Accounting data

- Accounts receivable and payable by age and by area
- Current debts, payback schedules, terms, history of paid back debts

Other data

- Charter capital amount and principal share holders
- Current and foreign currency account information

ofcf5e/Page 9

Instructor's notes:

The format of the information required by the investor or lender may differ from the information existing at the company, therefore, be ready to prepare special reports.

Share capital amounts and shareholders must be presented as sincerely as possible, as this is information regularly expected by most investors, especially western investors.

Remember Not to Respond with Vigue Answers to Specific Questions About the Project or Your Enterprise

Make sure you know the answers to the following questions:

Suppliers:
Who are they?
How reliable are they?
Are contracts signed with them?

Funds:
What amount is expected from each investor in the project?

Customers (related to the project):
Who are they?
Do they have money to pay for the products?
Are there contracts signed with them?

Management:
Who manages the project?

Project:
Cash flows
Supporting data
Debt repayment schedule

Competitors:
Are there existing competitors?
Are there potential competitors?
What market position will the project bring to the company?

ofcf5e/Page 10

Instructor's notes:

Make sure that all the answers to these questions are specific and detailed. An answer like " We need 5-10 billion Rubles for 4-8 months" can lose the opportunity for financing.

Are You Prepared For the Negotiating Process?

How will you handle the process?

- Who will be on the negotiating team?
- Who will organize and/or prepare additional information requested by the investor?
- At what point in the negotiation process will you allow full or partial access to the plant, current production data, technology, information on affiliated companies?
- Is there information you will not divulge until after a transaction has been completed?
- Are you prepared to allow information to be copied and removed from the plant, or would papers only be available for inspection on site?

Resolve these issues before getting to negotiations with the investor

ofcf5e/Page 11

Instructor's notes:

If there are outside consultants on the negotiating team, make sure that they have enough time to study your business and to know the intentions of the current shareholders and management in detail, so that they can appropriately support them.

Each Meeting is Critical

Make the initial call to set up a meeting, either through your professional financial advisor or another source who knows the potential investor (bank, legal advisor, other)

Bring complete documentation with you to the meeting

Take each meeting seriously

- You will have to convince different levels of management of the fund - the first person you talk with may be junior staff
- If impressed, he/she will make a recommendation for further investigation; a team will visit the plant
- The investor may wish to perform its own review of the enterprise
- If everything goes well, the proposed deal will be submitted to the investor's executive committee, which will make the decision whether or not to invest

ofcf5e/Page 12

Instructor's notes:

The negotiation team should be very dynamic to match the dynamism of a typical investor.

Have Your "Story" Well Prepared In Advance With All Senior Managers Fully Briefed

A prospective investor will want to visit the company	• Prepare an introduction to your company • Prepare a quick debriefing of your plan or project
A prospective investor will want to meet each member of the senior management	• Be able to present your story clearly and consistently by all members of senior management • Be consistent when talking with different potential investors
Prepare answers to all expected difficult questions	• Be ready to justify past performance even if it was not very good • Be able to explain how you have learned from past mistakes • Be prepared to discuss shareholding structure and related parties

Appearing to hide information or failure to provide information will discourage investors

Instructor's notes:

Emphasize:

Consistency is very important. An lender/investor will be turned off if he hears even a slightly different story from different members of senior management; he wants to lend to/invest in a company with a management team united in its objectives and strategy for achieving those objectives.

Explain:

Be especially careful in managing your first negotiations properly: if you make a deal with one investor, and you let it be known, then others may come to you spontaneously afterwards. In any case, use the process to build up your experience and disseminate this knowledge among your top managers.

Now that Preliminary Preparation is Complete, Let's Consider More Specific Preparation

1. *General preparation and approach to sources of external financing*

2. *Specific preparation for, approach to and negotiations with different sources*

Banks

For short and long term financing

Portfolio investors

For long term financing

Strategic investors

For long term financing

Public share/rights issues

For long term financing

ofcf5e/Page 14

Instructor's notes:

Explain:

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2

156

Bank Financing: What is Required and How Long Will It Take?

Tasks and Minimum Timetable

Task	Week																						
	1				5				10					15					20				
Project selection/evaluation																							
(including cash flow forecasting)	■	■	■	■																			
Business plan preparation					■	■	■																
Preparation of general company																							
information								■	■														
Bank selection								■	■	■	■												
Initial approach to banks										■	■	■	■	■	■								
Find appropriate guarantor / identify																							
appropriate collateral										■	■	■	■	■	■								
Negotiations/agrement												■	■	■	■	■	■						
Actual loan																		■					

ofcf5e/Page 15

Instructor's notes:

This conveys two main ideas:

First, the process of finding an investor is a long process requiring several months of hard work. This work is managed by different people and some stages, such as valuation of collateral, is usually performed by outside consultants.

Second, there is a certain sequence of steps to be performed, so tight project control is mandatory in order to avoid slippages, mistakes, and waste of management time.

15

157

Know What You Want and What You Can Offer to Obtain the Best Deal

The following questions are usually asked by bankers about the loan:

How much money is needed?	Agree the amount beforehand
For how long the money is needed?	Prepare a debt repayment schedule
What interest rate is desirable/sustainable for the project?	Know your desired minimum rate and sustainable maximum rate
From what sources the loan will be repaid?	Project revenues, overall company cash flow
Can the loan be guaranteed?	Customers, banks, government entities
What collateral exists?	Assess your available assets

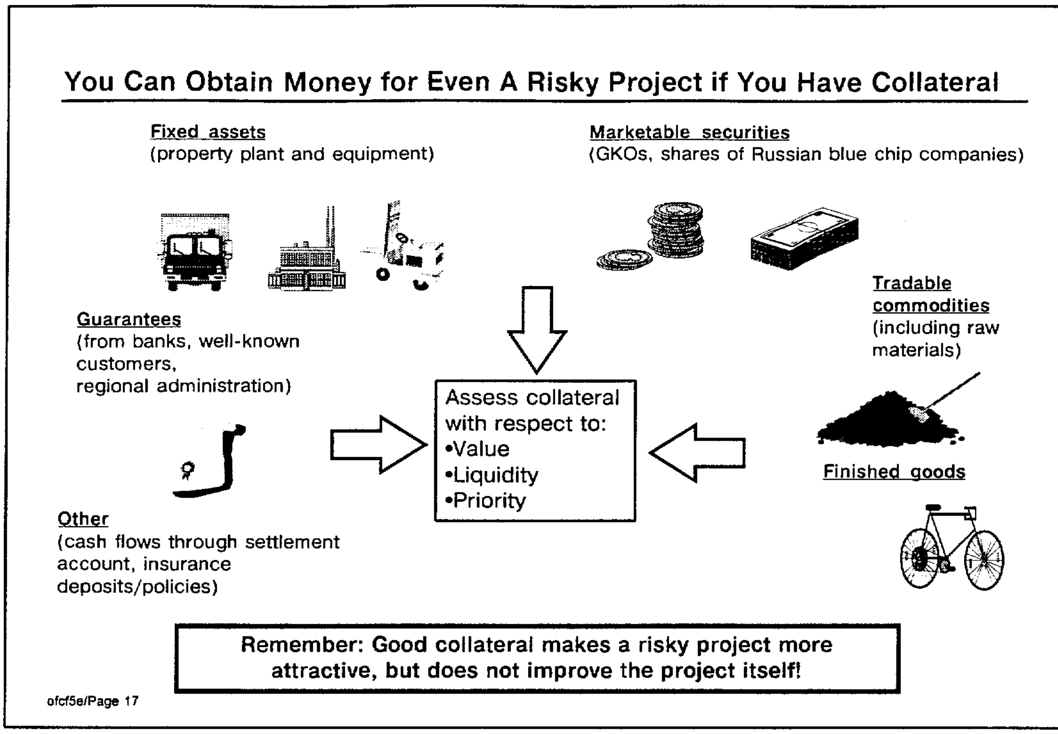
Know the possible answers before you have the meeting with the bankers

ofcf5e/Page 16

Instructor's notes:

It is advisable to make a list of answers to the typical bank questions in advance with the best and second best options written down. Some of these issues are technical and require substantial calculations, so do not rely on the negotiator to have 'clever' answers offhand at the talks with the bank.

Collateral is particularly important (covered on following slide).



Instructor's notes:

Fixed assets, tradable commodities and finished goods may require an independent valuation to be used as collateral.

You must also convincingly show how the asset(s) can be converted into cash (prove their liquidity) in order to get the bank to accept it as collateral.

When a loan is secured against the cash flows through a settlement account, the sustainable volume is extremely variable and is to be negotiated in each case.

Emphasize:

Although good collateral can make a risky project more attractive, banks are still looking to finance good projects. Collateral secures the loan repayment, but does not improve the project!

There are Plenty of Banks in Russia, But Not All Will Be Right for Your Company or Project

Type of Bank	Advantages	Disadvantages
Local banks	Better knowledge of the company Easy to approach Fewer communication costs	May not be financing such projects
Currently used banks	Better knowledge of the company	May not be interested
Specialized banks	Lower costs due to sector expertise; More interest in getting into the project	May not exist
Large banks	They are the only lenders for larger projects	A lot of information may be required There may be higher fees

ofcf5e/Page 18

Instructor's notes:

It will be easiest to begin by approaching your current bank; if the project fits their parameters, you are likely to get the money most quickly from this source. It is wise, however, to compare the interest rates they propose with other competing sources of financing.

The types of collateral you have to offer also has an impact on which bank to approach - regional government guarantees or local property will probably be more appropriate to local banks.

After Selecting the Right Bank, Make the Right Approach

Call the bank's general number and ask who is in charge of evaluating new financing projects

Call the designated person and provide a brief overview of your project(have a written outline with you when you call)

- Be direct, state the goal, find out if the bank is interested in your particular project

Be sure to communicate your firm's best side

- E.g. - working with international consulting firm, new product certification, 8 western customers, the Prime Minister just visited, monopolist, etc.

Be prepared to question the bank

- Why isn't the bank interested, which banks might be, what could be changed to get the bank interested?

Let the credit officer believe that financing is the only obstacle to the project

Follow-up on requests for additional information as soon as possible

- Banks may get hundreds of requests a day, delaying may prevent success
- Your response shows your company's true abilities (be timely and accurate)

ofcf5e/Page 19

Instructor's notes:

When calling the bank it is important to know from the first conversation who should be handling your inquiry; it may not be your first contact.

Try to make a good impression on all bank officers you deal with; do not be afraid or irritated if your are asked to repeat your story several times and have to answer the same questions. Be consistent in answering the same questions to different people.

To Obtain the Best Deal, Be Prepared to Negotiate From a Strong Position

Before Negotiations	Get as much information as possible about the bank ('Kommersant,' 'Dengi,' 'Expert,' 'Finansovie Izvestia,' 'Rinok Tsennikh Bumag,' & 'Interfax AiF' are good sources) If another less desirable bank has made a less attractive offer, use it as a bargaining tool in negotiations with the preferred bank
During Negotiations	Communicate only the necessary information: be careful in divulging confidential information Be conservative when discussing possible forms of collateral; start with the collateral you are most willing to offer, such as finished goods, and only discuss other forms of collateral if necessary, for example GKOs Prepare several options for the most important issues, but do not spend excessive time negotiating minor details
After Negotiations	After the initial meetings call the bank regularly to inquire about the progress of the deal (but no more than once a week)

ofcf5e/Page 20

Instructor's notes:

Remember that it is the loan that is negotiated and many issues that do not relate directly to the loan are not important - however, the bank may want information on some seemingly unrelated areas - be prepared to ask why the information is required and to provide it when necessary.

The Next Category: Portfolio Investors

1. *General preparation and approach to sources of external financing*

2. *Specific preparation for, approach to and negotiations with different sources*

Banks

For short and long term financing

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For long term financing

Strategic investors

For long term financing

Public share/rights issues

For long term financing

ofcf5e/Page 21

Instructor's notes:

Explain:

The most likely sources for external financing are listed here.

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2

163

The Search for a Portfolio Investor is Usually a Complex and Time-Consuming Effort

Tasks and Minimum Timetable

Task	Month 1	2	3	4	5	6	7	8	9	10
Project selection/evaluation (including cash flow forecasting)										
Business plan preparation										
Appoint financial advisor										
Financial due diligence (financial advisor)										
Legal due diligence (legal advisor)										
Investment memorandum preparation										
Company valuation										
Investor selection										
Initial approach to potential investor(s)										
Meetings/plant visits										
Due diligence (if performed by investor)										
General meeting of shareholders										
Negotiations/agreement										
Prepare Russian statutory prospectus										
Payment of new issue tax										
MinFin approval of prospectus										
Acutal investment										

ofcf5e/Page 22

Instructor's notes:

This slide shows that there are a large number of steps in finding and securing investment from portfolio investors, and that the process can take a significant amount of time.

Stress:

There are more than 100 portfolio investors in Russia now and a comparable amount of Russian portfolio investors. According to some estimates, this source of investment is the leading in equity finance now in Russia.

Usually the investors are funds (institutional investors) or rich individuals seeking profitable investment opportunities.

A Significant Investment in Document Preparation Will Be Needed

Several documents have to be prepared for portfolio investors

Business Plan | Cash Flow Forecasts | Investment Memoranda

- Russian statutory accounts do not provide a true picture of the financial or strategic position of an enterprise; potential investors require substantial additional documentation, in formats they can understand
- A business plan is required;
  - "Aid" funds usually have lists of specific information they wish to see, sometimes in specific required formats
- For most investors you must have:
  - Detailed cash flow forecasts with underlying assumptions and calculations
  - An investment memorandum which includes the results of financial and legal due diligence, and has been prepared by an experienced professional financial advisor

Instructor's notes:

Explain the meaning of these terms to the participants:

(1) **Business plan** is a document in which the company puts down the plan for the development of the company as a whole or of a particular project the company is undertaking. It usually states the main premises of all the sales, cost of sales and other important marketing information that were used in compiling the business plan.

(2) **Cash flow forecasts** were discussed in detail this morning. Some portfolio investors require them

(3) **Investment Memorandum** - the document that states the key factors for the investors. It usually includes results of a "due diligence" exercise - an independent review of the company's current situation by a well respected financial consulting firm. Most companies seek the assistance of reputable financial advisors (investment banks or consulting firms) for the preparation of investment memoranda.

Information required for several specific funds is included in the handouts.

Due diligence is described in more detail on the following slide.

Specifics of business plans and investment memoranda will be discussed later in the seminar.

What are Due Diligence and Valuation?

Financial and legal due diligence

- Financial due diligence is a review of the financial situation of your enterprise
  - Performed by an independent well-respected audit/consulting firm.
  - It is not an audit - it does not measure compliance with Russian financial reporting regulations
  - The objective is to determine the financial risks of investing in or being associated with the enterprise from an investor's point of view. This includes the identification of future potential financial liabilities of the company
- Legal due diligence is a review of the firm's privatization, current structure, and contracts with suppliers and customers, to identify any possible future legal claims against the company

Company valuation

- An estimation of a reasonable range of market values for the company's share capital, used by management to determine a percentage ownership to offer for a given amount of investment
- May be done by company or its financial advisors

ofcf5e/Page 24

Instructor's notes:

The financial term "Valuation" has two meanings: asset valuation and company valuation, also called business valuation

Asset valuation can be used in itself to put a value on assets being offered to a bank as collateral, or those the company is seeking to insure.

Company valuation is used to put a value on the share capital of the enterprise for negotiating with a potential equity investor in a private placement of shares or to price the shares in a public issue. One method of company valuation is based on valuation of all the assets of the enterprise. Company valuation will be discussed in detail later in the seminar.

It is Worth Spending Some Time Deciding Which Investor Approach

The search for an investor is a difficult process requiring specific knowledge

Russian portfolio investors

- They are 'young' companies
- Limited information about them
- Almost all located in Moscow
- Sometimes have limited resources
- Sometimes have very specific area of interest

Foreign portfolio investors

- Difficult to approach those located abroad
- Have strict investment rules
- Always have many other projects to consider
- Sometimes have limits on the amount and area of investment

It is sensible to hire a professional advisor to approach and negotiate with the investors on your behalf

With your advisor, rank the possible investors in order of most likely investment

ofcf5e/Page 25

Instructor's notes:

Stress: It is difficult to negotiate with portfolio investors if the company has limited experience in dealing with them and there are no professional negotiators or investment specialists on their side. It pays to have an experienced consultant on the company's side.

Be Prepared to Negotiate the Best Possible Deal

The following negotiating points need to be addressed

- Minimum investment the company will accept
- Maximum percentages of increased capital to offer for different levels of investment, what board representation, degree of control over major transactions
- Legal form in which investment will be made
- Required timing of investment; if capital expenditure program runs several years, how will funds be invested in the meantime and how will investment of the deferred portion of funds be ensured
- Rights to future share issues
- Commitments to restructuring (including divestment of non-core businesses and social assets, staff reduction), to switch registrar/banking/broker relationships to independent companies, to re-negotiate "related party" arrangements, to improve corporate governance
- Improvement of financial and management reporting systems to provide regular and timely information to the investor

ofcf5e/Page 26

Instructor's notes:

Explain the following issues:

The first two items on the list - minimum investment and maximum percentages of holding by the new investor stipulate the borders within the future investment will be made. The minimum investment is the amount that is indispensable to make the investment work, whereas the maximum percentage of increased capital to offer is the limit that will be acceptable to existing shareholders. As well one can hardly expect a large investment to be made in exchange of insignificant control as any investor that is making considerable investment wants to reduce its risk by assuming more control over the investee.

A commitment to improve in financial and management reporting systems is attractive to potential investors, because it means they will be better able to keep track of and manage their investment, thereby reducing risk. The investment will seem more attractive is you are able to present detailed plans for improvement of these systems.

Recent Changes in Legislation Will Have a Significant Impact

The Joint Stock Company Law of January 1, 1996, offers more protection to existing shareholders, but makes private placements and public issues of new shares more difficult, by:

- Requiring that holders of common shares be granted preemptive rights (the right to buy shares of any new issue in proportion to current holdings). **Private placements to particular institutions or investors are clearly in breach of preemptive rights of existing shareholders, unless the company is currently wholly owned by the investor to whom the new shares are being placed.**
- Requiring that companies buy back the shares (upon request) at fair market value of any shareholder not voting for reorganization, liquidation, or changes to the company's charter
- Requiring that those intending to purchase more than 30 percent of a company's shares, where the company has over 1000 ordinary shareholders, to disclose this intention 30 days in advance and to offer to buy the remaining shares from existing shareholders

It remains to be seen how these new provisions will be applied in practice in Russia!

ofcf5e/Page 27

Instructor's notes:

Preemptive rights and how to undertake rights issues will be discussed in detail when we talk about public issues of shares/rights.

(To Translator: I have bolded new sections of this slide -- number 27 in sequence)

Once You Have Reached Agreement, What Else Must You Do to Get the Funds?

In order to issue new shares to the investor, the enterprise will need to . . .

- Get shareholder approval at a general or extraordinary meeting of shareholders (notice for the meeting must be sent out 30 days in advance)
- Prepare a Russian statutory prospectus and submit it to the Federal Commission for Securities and Capital Markets or Ministry of Finance for approval
- Pay new issue tax
- get approval from the Federal Commission/MinFin and possibly from the Anti-Monopoly Committee

. . . before the transaction can take place

ofcf5e/Page 28

Instructor's notes:

If the management of the company does not have the controlling or majority holding of the shares of the company, it will have to prove the financial benefits of the proposed investment to its shareholders to get their approval. They may use a lot of the information from the business plan, company business valuation, due diligence reports and investment memorandums to communicate the necessary information to the shareholders.

Recent legislation designates the Federal Commission for Securities and Capital Markets as the body to approve new issue prospecti. However, in some geographical areas, the Commission has temporarily delegated this authority to the Ministry of Finance

Now On to the Most Common Form of Long Term Financing

1. General preparation and approach to sources of external financing

2. Specific preparation for, approach to and negotiations with different sources

Banks

For short and long term financing

Portfolio investors

For long term financing

Strategic investors

For long term financing

Public share/rights issues

For long term financing

ofcf5e/Page 29

Instructor's notes:

Explain:

The most likely sources for external financing are listed here.

Some of these options may be undertaken simultaneously (bank financing and strategic investor search, for example), but some are mutually exclusive (a public share issue and a strategic investor search, for example).

Note:

We do not discuss Russian government sources of finance, which might be quite beneficial in some cases. Because negotiations with these sources are primarily political, they are not covered in this seminar.

We will begin by discussing general preparation which is necessary regardless of the source of external financing pursued, then we will discuss specifics of preparation, approach, and negotiations with each different source of funds.

2

171

Searching for a Strategic Investor Can Be Even More Time-Consuming than Searching for Portfolio Investors

Tasks and Minimum Timetable

Task	Month																																				
	1				2				3				4				5				6				7				8				9				10
Project selection/evaluation (including cash																																					
flow forecasting)																																					
Appoint financial advisor																																					
Financial due diligence (financial advisor)																																					
Legal due diligence (legal advisor)																																					
Investment memorandum preparation																																					
Company valuation																																					
Investor selection																																					
Initial approach to first potential investor																																					
Meetings/plant visits																																					
Negotiations/agreement																																					
(repeat 3 steps above for each new																																					
potential investor)																																					
General meeting of shareholders																																					
Prepare Russian statutory prospectus																																					
Payment of new issue tax																																					
MinFin approval of prospectus																																					
Acutal investment																																					

ofcf5e/Page 30

Instructor's notes:

This is more difficult than the previous options, but there are some companies and industries which attract specifically this type of investment (larger companies, companies requiring specific equipment).

Again, this slide primarily shows the complexity of the process of attracting a strategic investor. The minimum amount of time required is longer than that required for a portfolio investor, because more time must be spent in deciding who to approach and it may be necessary to prepare more detailed information on the company.

The search for a strategic investor may take substantially more time than shown here, because unlike negotiations with new potential strategic investor should begin only after the company has failed to reach agreement in previous negotiations.

Finding the Right Strategic Investor Will Require Professional Assistance

Unlike portfolio investors resident in Russia, strategic investors may come from anywhere in the world and may have little or no knowledge of:

- The history of Russian enterprises (operations, reporting, organization, privatization, etc)
- The true nature of political and economic risk
- Russian accounting standards and financial reporting requirements

Thus, a professional financial advisor is even more important

A financial advisor can:

- Help you develop criteria for your ideal investor
- Help you qualify and rank potential investors
- Prepare financial information in a format the investor will understand
- Place the risks of investing in Russia in proper perspective for investors
- Negotiate terms on behalf of the enterprise

ofcf5e/Page 31

Instructor's notes:

What is said about the fears of portfolio investor is true for the strategic investor as well, but there are specific risks as well. They will require substantially more information about the production performance and the financial regulations in the country as a whole and in the industry as well. Strategic investors are usually production firms and have less financial resources than professional investors therefore they will be more stringent in requiring information and its valuation.

Regarding "true nature of political and economic risk in Russia" - the foreign press has often been sensationalist, highlighting accidents, scandals and other items of secondary importance

Many Issues Need to be Considered when Qualifying and Ranking Potential Strategic Investors

- Which investors are likely to provide an investment of the required size?
- What do you want from a strategic investor besides money? Who can provide it?
- What synergy, cost savings, customer base or raw materials can you offer to a strategic investor?
- Which investor has a strategic vision similar to yours?
- What kind of management and company culture can your workforce accommodate?

Answers to these questions will help you to define the profile of your ideal strategic investor

ofcf5e/Page 32

Instructor's notes:

Though these questions seem obvious and self-explanatory, it is important to analyze these issues formally with the involvement of the top management and controlling shareholders in order to prepare a strategy that the company can sustain without major disruption once the strategic investor starts participating in the decisions.

Disclosure to a Potential Strategic Investor is a Particularly Delicate Process

When considering investment in your enterprise, a strategic investor will want access to specific and complete information about:

- Your production
- The technology you use
- Your customers and suppliers

If he comes from a related business sector, he will understand your own and will want access to confidential information

Unlike the portfolio investor search, you ideally want to speak with only one potential strategic investor at a time

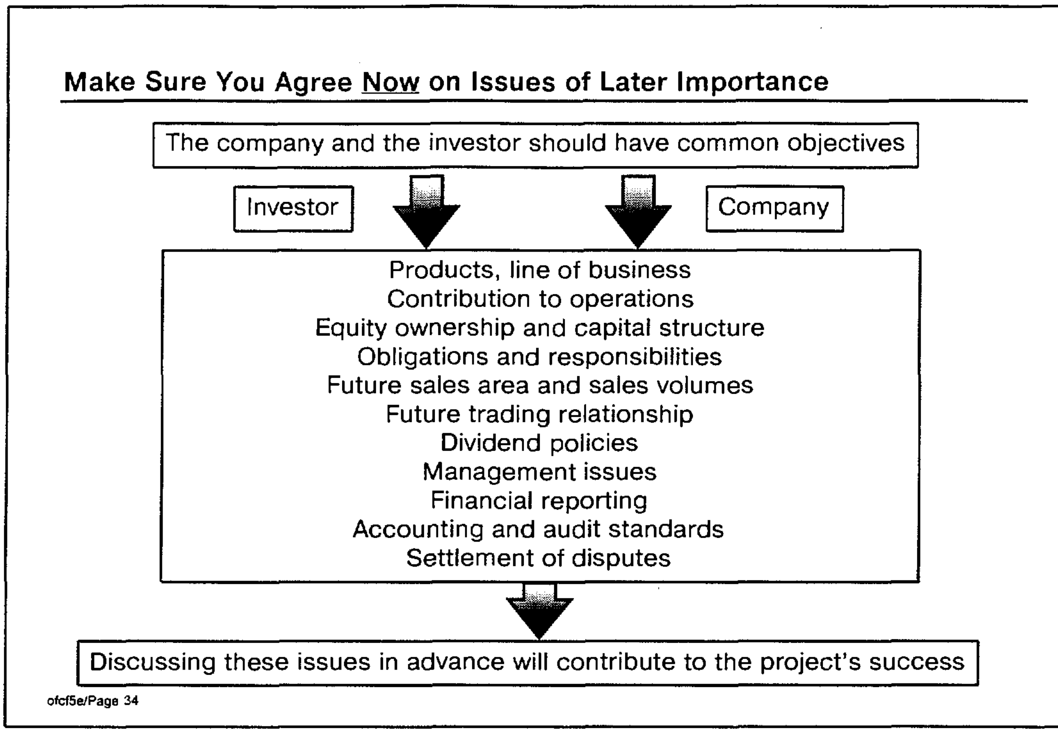
- Approach each new potential investor only after previous have failed

ofcf5e/Page 33

Instructor's notes:

The nature itself of a strategic investment requires the release of confidential information as the company will almost certainly have to co-ordinate its efforts with the investor in the future and this coordination will relate not only to financial issues, but to operational ones as well.

Potential strategic investors will be companies in your industry or in a related industry; they are often your competitors - so you want to release confidential information to as few of them as possible. This is why it is particularly important to select the best potential strategic investor to talk with first, and to try to close a deal with that investor.



Instructor's notes:

Products. lines of business:

Major goals/strategy of both partners and products, industries, markets, customers served

Contribution to the operations:

Agreement should specify how non-cash contributions, including machinery, technology, distribution system, customer list, etc., will be valued.

Agreement should be reached on raising loan funds, loan guarantees by partners, working capital financing, future increase of equity capital, etc.

Obligations and responsibilities:

Responsibilities of investor may include providing new machinery and technology, training production work force, production quality control, etc.; the Russian company is usually responsible for relationships with local authorities and with labor unions, etc.

Future trading relationships:

Would enterprise accept exclusion from certain geographic regions or product areas?

Would enterprise grant or expect to receive preferential trading terms?

What would attitude be to open access to technological research/transfer of patented technology or use of license arrangements?

Management issues are discussed on the next slide.

Management Issues Can Be the Most Difficult to Handle

Management issues are vital for the company's success

- What will the composition and authority of the Board of Directors be?
- How will members of the Board of Directors be appointed?
- How far will the authority of executive officers extend?
- How will executive officers be appointed?
- How will the organizational structure of the company change?
- What will the new reporting structure look like?
- How will key strategic and operational decisions be made?
- What internal audit/control procedures will be used?

ofcf5e/Page 35

Instructor's notes:

After Reaching Agreement on Issues and Details, the Deal Must be Closed

Same 'logistical' issues as with portfolio investor

Same constraints imposed by the Joint Stock Company Law

May take more time to receive investment than it would from a portfolio investor -

- More detailed study of the company's operations and financial performance
- Usually a larger percentage of shares are sold to strategic investor than to portfolio investor
- Non-cash contributions must be arranged
- Detailed strategy must be developed

Arrange special task forces of the company's management and the investor to monitor implementation

ofcf5e/Page 36

Instructor's notes:

The special working team should include the person who was negotiating the deal with the investor.

It has to be wider than a team working with portfolio investor or bank as it will have to include operations managers, may be marketing personnel and other specialists.

Finally, Let's Discuss the Least Common Form of Long-Term Financing in Russia Today

1. General preparation and approach to sources of external financing

2. Specific preparation for, approach to and negotiations with different sources

Banks

For short and long term financing

Portfolio investors

For long term financing

Strategic investors

For long term financing

Public share/rights issues

For long term financing

ofcf5e/Page 37

Instructor's notes:

Explain:

The most likely sources for external financing are listed here.

Some of these options may be undertaken simultaneously (bank financing and strategic investor search, for example), but some are mutually exclusive (a public share issue and a strategic investor search, for example).

Note:

We do not discuss Russian government sources of finance, which might be quite beneficial in some cases. Because negotiations with these sources are primarily political, they are not covered in this seminar.

We will begin by discussing general preparation which is necessary regardless of the source of external financing pursued, then we will discuss specifics of preparation, approach, and negotiations with each different source of funds.

Public Issues Are the Most Complex and Time Consuming Source of Long-Term Investment

Tasks and Minimum Timetable

Task	Month									
	1	2	3	4	5	6	7	8	9	10
Project selection/evaluation (including cash flow forecasting)										
Appoint financial advisor										
Financial due diligence (financial advisor)										
Legal due diligence (legal advisor)										
Company valuation										
Selling memorandum (western-type issue prospectus) preparation										
General meeting of shareholders										
Selling memorandum verification										
Russian statutory prospectus preparation										
Appointment of lead manager of issue										
Enterprise public relations										
Payment of new issue tax										
Initial MinFin approval of prospectus										
Establishment of selling syndicate										
Development of receiving bank procedures										
Pre-selling of issue, arranging underwriting										
Pricing of the issue										
Final MinFin approval of prospectus (with pricing)										
Issue public relations										
Prospectus and selling memorandum printing										
"Road shows"										
Distribution of materials										
Offer peroid										
Distribution of register extracts										

ofcf5e/Page 38

Instructor's notes:

Very few privatized Russian enterprises have undertaken this difficult exercise. But as the economy stabilizes and the capital markets develop, it will be an important source of finance.

In all countries, public share issues must follow more stringent legal requirements than private placements, because an offer is being made to the public at large, and not only to professional investors.

Russian legislation for public share issues has become more stringent because of 'pyramid' and other scandals (MMM) in the capital markets.

Professionals and experienced financial and legal advisors are obligatory to obtain this type of financing.

Public Issues Take A Long Time to Prepare, But A Short Time to Implement

You will have to prepare a western-style share prospectus and selling memorandum for all potential foreign buyers

- The same information must be prepared for Russian portfolio investors

Usually it takes a longer time to prepare a thorough prospectus than it does an investment memorandum

A public issue requires the following tasks not needed for private placements:

- Setting up a selling structure, which may require the assistance of investment consultants
- Public relations, which also may require professional assistance
- Presentations to groups of potential investors ("road shows")
- Organization of a system of "receiving banks" to actually accept money for the shares
- Printing and distribution of prospectus, selling memorandum, application forms

ofcf5e/Page 39

Instructor's notes:

Selling structure: appointment of lead manager of the issue, establishment of a syndicate of brokers/dealers to sell the issue

Public relations: general enterprise PR before MinFin approval of Russian statutory prospectus, advertising of the issue itself afterwards

The effort that is necessary to make for the public issue of shares is of a different type that the company's management is accustomed to, so outside consultants are the only solution to most of the firms.

Pre-Sell the Issue to Ensure Success

A public issue must be successful. Otherwise, the company's overall reputation in the financial community may be tarnished

As soon as documentation is prepared, begin talks with potential portfolio investors, as you would for a private placement

In addition to receiving commitments to buy a portion of the public issue, these talks will reveal

- If the issue is too large
- If the issue is too small
- If the initial pricing of the shares is too high or too low

Successful pre-selling negotiations are very important in public issues

ofcf5e/Page 40

Instructor's notes:

Any failed attempt to raise capital will have a negative impact on the company's chance of raising funds in the future.

Discussions with the potential investors before the offer period can demonstrate whether or not the issue is likely to succeed.

At this stage, publicity of the company itself is extremely important. The best publicity at this stage is not advertising per se, but interviews with management, articles, etc. in well respected media.

The company should consider increasing the size of the issue only if it has additional projects for financing that have met the company's strategic and financial criteria.

Once it is determined that the issue is likely to succeed, and the prospectus has been approved by the Ministry of Finance, advertising of the issue itself serves to close deals with undecided portfolio investors, to build general awareness of the success of the company and to build momentum before and during the offer period.

How Are New Shares Usually Priced?

Start with a comprehensive company valuation to determine the theoretical value of your company's equity

Submit Russian statutory prospectus to Federal Commission for Securities and Capital Markets/MinFin without a price, if possible

Once pricing has been determined, resubmit prospectus to Federal Commission/MinFin with price for quick approval

Adjust price up or down as talks proceed with potential portfolio investors (while attempting to pre-sell a portion of the issue)

ofcf5e/Page 41

Instructor's notes:

This scheme represents the desired course of action, as the submission of prospectus without the price may serve as an important tool for the valuation of the shares, especially for the companies that have not been selling their shares before. The local department of the Federal Commission for Securities and Capital Markets/Ministry of Finance does not have to approve the Draft, it has to approve only the final document that will have the formal approval of the Federal Commission/MinFin.

The success of this scheme depends entirely on the companies relationship with the local government bodies.

Key Success Factors in Placing Your Issue

- With the right preparation, the offer period need not be long
  - A a rule of thumb, durations ranging from 3 weeks to 2-3 months are reasonable
  - The longer the offer lasts, the larger administrative expenses become
- Always set a firm closing date, so the issue appears more attractive
- Issue register extracts immediately after the close of the issue - it is good publicity
- Remember, if you treat your investors well during the issue and afterwards (with good corporate governance and extensive reporting to investors), raising funds through another share issue will be considerably easier in the future

ofcf5e/Page 42

Instructor's notes:

During the offer period have control over the process and arrange for additional clerical resources for the first and the last days of the offer period as it is usually the time when most of the bids are made.

You may use the facilities and the personnel of the agencies (now primarily commercial brokers) that were selling shares for vouchers during the privatization years, it may be cheaper and more efficient than any other options.

What are Preemptive Rights and What Do They Mean for a Company Wishing to Raise Financing?

What are preemptive rights?

- The Joint Stock Company Law of January 1, 1996 established preemptive rights of shareholders of Russian joint stock companies. This means that the current shareholders of a company have prior rights to subscribe for any new issues of shares for cash before they can be offered to anyone else. This ensures that the level of influence or control that a shareholder has is not diluted by any issue without his prior knowledge and agreement.

What do they mean?

- The existence of preemptive rights means that companies cannot issue equity shares, convertible bonds, or warrants (options for purchasing shares) for cash other than to the current equity shareholders of the company, except with their prior approval in a general meeting of shareholders.

Instructor's notes:

These are general principles relating to rights issues in countries with preemptive rights. Rights issues have not been done in Russia, and it remains to be seen how Russian companies will practically apply these principles.

Instead of Issuing Shares Directly to New Shareholders, a Company Issues Share Rights to Existing Shareholders

Marketing a rights issue is very similar to marketing a public share issue.

- In a rights issue, existing shareholders are sent warrants showing that they own one "right" for each share they hold. Any number of rights required to purchase a new share may be specified (i.e., "5 rights entitle a shareholder to buy one additional share at a subscription price of RUR 130").
- A shareholder who does not wish to subscribe to the new shares may sell the rights to another investor, giving them the opportunity to subscribe for the new shares instead.
- If shares are already openly traded, the subscription price will need to be set slightly less than the value of existing shares so that the new shares will be purchased (the rights will be exercised).

The subscription price times the number of new shares will be maximum amount of funds raised by the issuing company.

ofcf5e/Page 44

Instructor's notes:

The value of a right to a shareholder is the difference between the rights subscription price and the value of the new shares after the transaction takes place divided by the number of rights required to purchase a new share.

Rather than assuming that an individual shareholder either subscribes for the whole rights issue or sells his or her rights in their entirety, it is possible for a shareholder to subscribe for part of the rights and to sell the rest. A "break even point" can be calculated whereby the cash received from selling part of the rights exactly covers the shareholder's cash outflow on exercising the remaining rights (i.e. purchasing the shares to which the holder has rights).

It is arguable that expenses in a preemptive common stock rights issue are greater then the expense involved in a direct offering of common shares to the public due to additional printing and mailing costs, expenses associated with the handling of rights and processing of subscriptions, and the longer time required for consummation of the financing, as well as the greater uncertainty of the underwriting.

How Can a Company Be Assured of Raising the Funds It Needs?

To guard against the danger that the share price may end up below the subscription price (and the new shares are not subscribed to), the issuing company may try to arrange for the issue to be underwritten (usually by a bank). Instead of actually buying the issue as in a cash share issue the underwriters are paid a "standby fee." In return, they promise to buy all unsubscribed shares at the subscription price (often at a specified amount) in the case that not all rights are exercised.

Even if it makes logical sense to exercise rights, there may be some rights which are not exercised, due to either ignorance of shareholders (or the fact they are on vacation, etc.). The underwriters may cover this shortfall, or the company may give shareholders ovesubscription privileges, allowing them to buy unsubscribed shares at the subscription price. Of course, these shareholders would then profit at the expense of those who had not exercised or sold their rights for whatever reason.

ofcf5e/Page 45

Instructor's notes:

The fact that underwriters do not purchase the shares outright as in a cash share issue makes underwriting more uncertain, especially in Russia, where the health of many financial institutions is in question, and where the concept of underwriting is not well understood in general.

Seminar Agenda

Session 1:	Finance Overview
Session 2:	Project Selection
Session 3:	Sources of Short-Term Finance
Session 4:	Sources of Long-Term Finance
Session 5:	Preparation, Approach, Negotiations
Session 6:	**Specifics of a Business Plan, Investment Memorandum and Issue Prospectus**
Session 7:	Company Valuation
Session 8:	Summary

ofcf6e/Page 1

Instructor's notes:

In this session, we will discuss what is needed to prepare a business plan, investment memorandum or prospectus. We will give some specific examples of requirements of several major investors.

Ask attendees if they have prepared a business plan or an investment memorandum. If someone has, ask him/her what information went into the document and how long it took to prepare.

Purpose of A Typical Business Plan

A business plan describes a line of business or a particular project and all of its operational characteristics over a period of time, including supporting assumptions

What is the purpose of a business plan:

- Internal use
  - Operating plan to guide project implementation and resource allocation, and to monitor success
  - To embody a common strategy and mobilize company personnel on the project
- External use
  - For small to medium size enterprises - to attract venture capital
  - For larger enterprises - to attract trade partners or financing for a particular project, or to be incorporated into an investment memorandum or issue prospectus in order to attract financing for the entire enterprise

Who reads it:

- Senior and middle management of the enterprise
- Potential trade partners
- Potential providers of debt or equity financing

ofcf6e/Page 2

Instructor's notes:

Give some examples of business plans you have seen, or ask the audience to provide examples.

Here is an example from a brewery in a former soviet republic:

It was a description of the brewing business in Lithuania and of the market prospects for the company. The business plan offered several suggestions to improve marketing, increase efficiency, and to reduce costs. It also included an analysis of alternatives for the company with regard to an unfinished brewery.

This business plan was INTERNAL, but was structured so that the company could use the first sections, which were largely descriptive, as the basis for external use documents (publicized business plan, investment memorandum, issue prospectus).

<u>Emphasize</u>:

Some information such as strategic plans or details of new products should be tightly held within the company.

A business plan is essential when seeking external long-term finance

An Investment Memorandum and Issue Prospectus - How Do They Differ From a Business Plan?

An investment memorandum is typically sent to portfolio investors or other professional investors providing long-term debt and equity. It differs from a business plan in that it:

- Includes a description of the entire enterprise, including all businesses and subsidiaries, not just of the specific project
- Is generally for external use only
- Is used to attract financing for the entire enterprise through a private placement of debt or equity
- Is typically distributed to a very limited number of potential lenders or investors

An issue prospectus differs from an investment memorandum in that it:

- Is typically distributed to professional investors and to anyone else who wants it in the general public
- Is used to attract financing through public issues of equity or debt

Now let's look at each one in a little more detail!

ofcf8e/Page 3

Instructor's notes:

Emphasize:

While a prospectus for a public issue of shares must be very thorough, some details and company secrets should not be released to the public. This is a balancing act. Potential investors expect thorough information on the company, but the company cannot afford for its secrets to get into the hands of its competitors.

An investment memorandum for a private placement of shares, however, may be distributed selectively to a limited number of qualified potential investors under a confidentiality agreement.

Contents of A Business Plan, Investment Memorandum, and Issue Prospectus

CONTENTS	Business plan	Investment memorandum	Issue prospectus
Market assessment and plan	●	●	●
Production plan	●	●	●
Organizational plan	●	●	●
Financial plan	●	●	●
Overall business development plan	●	●	●
Investment risks		●	●
History of the enterprise		●	●
Detailed information on subsidiaries		●	●
Breakdown of share capital and shareholders		●	●
Explanation of related parties		●	●
Extensive financial information		●	●
Structure of the transaction		●	●
Accounts restated to IAS/GAAP			●
Current share trading			●
Corporate governance			●
Details of the issue			●

ofcf6e/Page 4

Instructor's notes:

<u>Explain</u>:

This slide gives an overview of the different information each type of document should provide. In the case of an issue prospectus, some of this information is required by law.

[The contents of each is described in more detail in following slides]

A Business Plan Describes and Persuades, But Must Be Backed By Facts

A business plan begins with an executive summary, followed by details for the more involved reader, including a:

- Market review/assessment
  - How the project will satisfy market requirements
- Strategy for exploiting the current market situation
  - How to implement the strategy and why it is better than the competitor's strategy
- Production plan
  - How to produce, how much to produce, where to source raw materials, prices, quantities to purchase, production costs
- Organization plan
  - Key personnel, skills assessment, required labor and costs
- Financial plan
  - Combines market, sales, production, and other data to provide cash requirements and projected cash returns
- Overall business development plan
  - Critical elements, milestones, exit strategies for investors, inherent risks

ofcf6e/Page 5

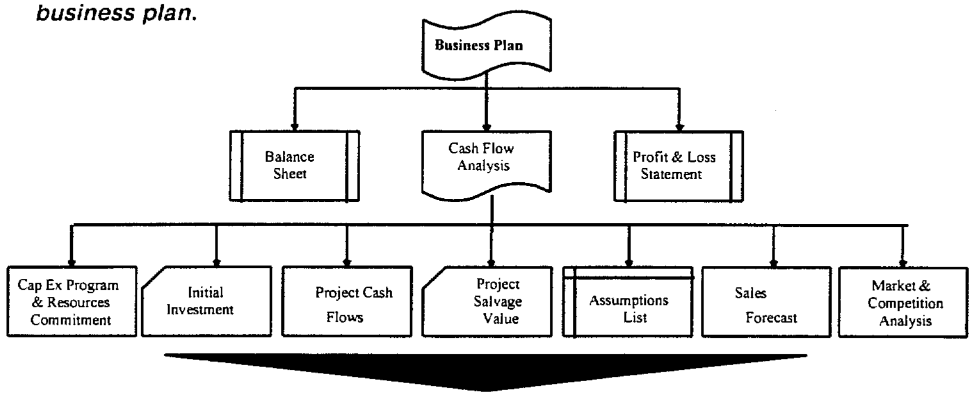
Instructor's notes:

Explain:

There are many ways to organize this information, but it all must be in the business plan. For the Lithuanian brewery example earlier, the consultants organized the information in the same way as the financial statements: short term assets, long term assets and intangibles (strengths and weaknesses of the firm); then each line element of the income statement was analyzed in detail.

The Business Plan Must Be Complete, Thorough, and Well-Supported

Many financial documents and analyses support the various sections of the business plan.



- Net Present Value
- Internal Rate of Return
- Sensitivity Analysis

ofcf6e/Page 6

Instructor's notes:

This information, in most Russian companies, is buried in pools of paper that individual managers protect. We all know the scenario. The commercial director wants some information - he calls accounting and is told the information does not exist, even though he saw the report just two weeks before. So he calls the economic director, who calls someone else in the accounting department, who gets the information to the commercial director.

This example is provided to encourage managers to break down these information barriers within their companies so that the companies work more efficiently and managers can make better decisions.

An Investment Memorandum Must Contain More Information Than a Business Plan

In addition to the contents of a business plan, an investment memorandum includes:

- Purpose, status and use of the investment memorandum
- Investment risks (capital markets, share valuation, political, economic, reporting and disclosure, accounting and audit, taxation, etc.)
- Structure of the transaction
- History of the enterprise
- Detailed information on subsidiaries
- Detailed breakdown of share capital and shareholders and debt structure and creditors, including percentage owned by management and/or directors, stock options, affiliated companies
- Accounts confirmed by Russian statutory audit, international standard financial due diligence suggested
- Explanatory notes to financial information

ofcf6e/Page 7

Instructor's notes:

Additional comment

Some of these items may appear in a business plan, but they are always included in an investment memorandum. Of course, a business plan may contain important technical information that does not get included in an investment memorandum, such as technical specifications for a new product.

194

An Issue Prospectus Must Satisfy Legal Requirements

According to Russian legislation, an issue prospectus is a statutory document for open joint stock companies wishing to increase their number of shares. This may accomplished be through:

- Privatization
- Share dividends (including share distributions to account for asset revaluation)
- New share issues (private placements or public issues)

Legal requirements are set out in MinFin instruction #2 of March 2, 1992, and include:

- Basic information about the issuer
- Information about the issuer's financial status
- Information about the issue of securities

ofcf6e/Page 8

Instructor's notes:

Additional information

General information includes: name, legal status and location of the company; information about the senior management of the company and their previous experience; legal entities and individuals owning more than 5% of share capital.

Financial information includes: statutory balance sheet, Profit & Loss statement pro forma, authorized capital, past capital expenditure, business activity, and property

Security issue information includes: type and form of securities, underwriters, interest and dividend payments, and location where dividends can be received

An Issue Prospectus Must Also Satisfy Capital Market Requirements

An issue prospectus is used by any potential investor, whether a sophisticated portfolio investor or an individual. By law it must contain all necessary information that will affect an investment decision, such as:

- Responsibility for preparation of financial information
- Audited financial information (preferably by an international audit firm)
- USD restatement and IAS reformatted accounts suggested
- Current share trading
- Corporate governance
- Application procedures for purchase of shares, bonds
- Detail of governing laws applicable to public share issues

And all information must be accurate and verifiable

So keep in mind that: → Enterprise directors are personally responsible for all contents of an issue prospectus

ofcf6e/Page 9

Instructor's notes:

Additional information

Accuracy of the information is extremely important. Enterprise directors may face criminal charges for any omissions or incorrect information which lead to an investor making an incorrect investment decision based on the issue prospectus.

Emphasize:

Foreign investors generally require audited financial statements according to international accounting standards (IAS). These should be in hard currency and consolidated. Costs vary to have these prepared, but a moderately large size firm may spend $200,000 easily on preparing these.

After Learning About the Various Types of Information Documents, It Should be Clearer Why Financial Advisors Play A Major Role in Acquiring Finance

Business plans is informational though not exhaustively descriptive; typically, they are not legally binding

- The financial advisor can guide you through the process of writing a business plan or help you write it

Investment memoranda are sent only to a limited number of investment professionals, but are very detailed and require experienced professionals to be completed properly

- The financial advisor should be responsible for development of an investment memorandum

Issue prospectuses may be sent to any individual wanting to invest his savings. Therefore, these documents must be professionally researched, developed, and written

- The financial advisor must be heavily involved in the development of and be responsible for finalizing the issue prospectus. Ultimate responsibility will go to the Director of the issuing enterprise who will be fully responsible for accuracy and completeness in the details of past, present and future operations

ofcf6e/Page 10

Instructor's notes:

Additional Information

In addition to these reasons, a financial advisor can assist you in selecting the best type of financing for your company, and when you are ready to contact investors, can help you choose the sources most appropriate for your needs through better developed channels and personal contacts.

Financial advisors should be carefully selected. There should be a balance between cost and service provided. Companies should beware of individuals who promise to find financing for a fee. Always look into the firm's background. Get a list of references and follow up with them.

Questions to ask references:

Were they happy with the service?

Would they use that advisor again?

How long did the process take, and how much was required of senior management?

Did the financial advisor assist in negotiations?

What other services did the advisor provide?

Were these included in the fee?

Example 6.1 - Consider What the EBRD Requires In An Information Document Presenting a Financing Opportunity

Companies seeking private sector development financing from the EBRD should be prepared to submit:

- A **Business Plan** which includes
  - A brief historical and current description of the company
  - What the company's plans are during the term of the proposed loan
    - Products
    - Management
    - Marketing
    - Production facilities
  - An Investment Plan which
    - Focuses on the investment program, including its total cost
    - Describes what the company will do with the proceeds of the loan
    - Details what machinery will be purchased and where it will be installed
    - Includes a detailed financing plan which spells out the timing of all financial requirements, and how each will be met

ofcf6e/Page 11

Instructor's notes:

A handout EBRD business plan template is included in the handout materials, together with an IFC investment proposal template, for which information is more preliminary in nature.

Summary on Investment Information Documents

- A business plan, investment memorandum and issue prospectus can be used to communicate information about a company to a particular target audience
- A business plan is typically an internal document, or provided selectively to banks or business partners
- An investment memorandum is used for private placements and bank loans
- An issue prospectus is a widely distributed document covered by several laws on investing
- All of these documents take time to prepare and contain a lot of information
- Some investors, such as IFC or EBRD, have specific formats for business plans they will consider
- A financial advisor, consultant, accountant, lawyer or all four types of assistance will help make your document successful

ofcf6e/Page 12

Instructor's notes:

199

Seminar Agenda

Session 1:	Finance Overview
Session 2:	Project Selection
Session 3:	Sources of Short-Term Finance
Session 4:	Sources of Long-Term Finance
Session 5:	Preparation, Approach, Negotiations
Session 6:	Specifics of a Business Plan, Investment Memorandum and Issue Prospectus
Session 7:	**Company Valuation**
Session 8:	Summary

ofcf7e/Page 1

Instructor's notes:

Valuation is used for different purposes, most of which relate to obtaining finance. We will discuss what valuation is, who it is for, how it is used, and who should perform valuation.

Discussion:

Ask several of the participants what valuation is and what it is used for.

What Is Valuation? Why Is It Used?

There are two types of valuation:

1) ***Asset valuation* estimates the true market value of an enterprise's tangible assets. It is used:**

- For determining a price at which to sell assets
- For determining the value of assets to be used as collateral for a loan
- For updating book value of assets in accounts (for tax reduction or other reasons)
- For determining value of assets for insurance purposes
- In joint venture negotiations to determine the value of assets to be contributed to the JV by either party
- As a part of business valuation

2) ***Business valuation* estimates the true market value of the business operations of a going concern. It is used:**

- For negotiating with potential strategic or portfolio investors about the price of different percentage shareholdings in the enterprise
- For pricing shares in a public issue

ofcf7e/Page 2

Instructor's notes:

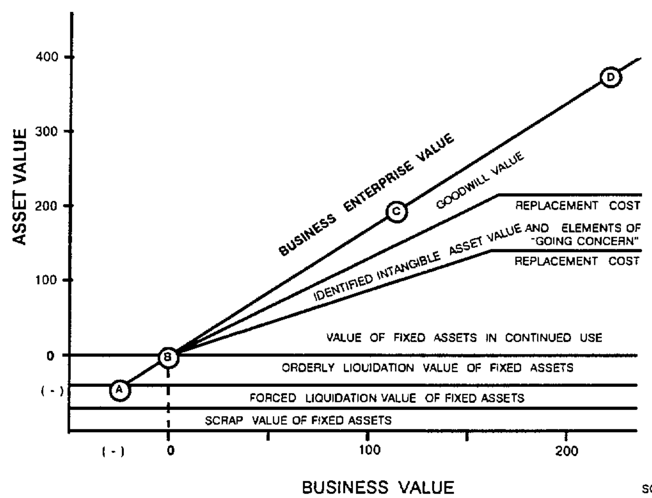
Explain:

We will discuss the different uses of the two types of valuation in more detail later.

Asset valuation and business valuation are different, but not unrelated. The interaction between business value, earnings, and asset value is shown on the following slide

Greater earnings generate higher business value but greater earnings do not necessarily generate higher asset value.

Asset Valuation and Business Valuation Are Different But Related



Point A.: The business is losing money and will be forced to liquidate.

Point B: The business is breaking even, but could start losing money. An orderly liquidation is appropriate.

Point C: The business has normal earnings. The business has both tangible and intangible assets with minimal economic obsolescence.

Point D: The business is highly profitable. Tangible and intangible assets reflect value in use. The value of superior earnings would be reflected in goodwill.

SOURCE: Smith, Parr

ofcf7e/Page 3

Instructor's notes:

Explain:

Two main points:

1. In a normal economic environment, this chart reflects the relationship between business and asset values.

2. In Russia at the present time, asset value often exceeds business value. In a stable economy, if this were true, someone would buy the business and sell off the assets to make a profit.

3. Asset values will tend to give higher values than business valuations based on cash flows at times of low capacity utilization.

Three Common Types of "Value": Fair Market Value

Three common types of value are:

- **Fair Market Value**
- Liquidation Value
- Book Value

Fair Market Value (FMV):

- It is intended to be a reasonable estimate of the price at which property would change hands between two willing parties.
- The actual price paid in a transaction may differ from fair market value due to such factors as:
  - The motivation of the parties
  - The negotiation skills of the parties
  - The financial structure of the transaction
- This definition assumes the consideration is paid in cash. Consideration paid in the form of installment payments, seller financing, or contribution of intangible assets by the buyer, could affect the price paid

ofcf7e/Page 4

Instructor's notes:

Emphasize:

These values may or may not be the same.

Note:

The relationship between fair market value (FMV) and book value is different under Russian accounting and GAAP (General Accepted Accounting Principles) accounting:

Russian: FMV $\neq$ Book value

(typically, book values are way overvalued or way undervalued)

GAAP: FMV > Book value

(assets are typically carried at original cost)

Three Common Types of "Value": Liquidation and Book Value

Three common types of value are:

- Fair Market Value
- **Liquidation Value**
- **Book Value**

Liquidation Value:

- Assumes the company's operations are expected to be discontinued and that its assets will be sold on a "piecemeal" basis
- Two levels of liquidation value:
  - *Orderly liquidation:* assumes assets are sold over a reasonable time period (6 months to a year) to obtain the highest price
  - *Forced liquidation:* assumes assets are sold as quickly as possible, perhaps on an auction basis
- Considers the costs incurred to sell the assets, such as selling fees
- Typically represents the minimum value for a business

Book Value is the value of assets in financial accounts of the enterprise

ofcf7e/Page 5

Instructor's notes:

Explain:

The book value on the balance sheet is not the same as fair market value (FMV) of the asset, though it may be an appropriate starting point for asset valuation. Note that in some cases (recently bought raw materials) the book value is the same or very close to the FMV.

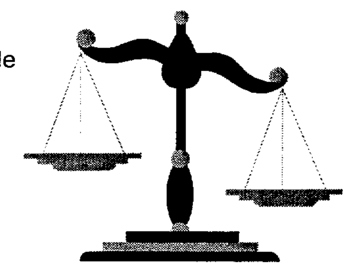
Liquidation means selling immediately at low prices to the highest bidder.

"Value" is Relative

Ultimately, either an asset or the total business will be worth what someone is willing to pay for it, at a given time

This value will be different:

- For different purchasers; and
- For different circumstances of the sale



ofcf7e/Page6

Instructor's notes:

205

Purpose and Audience of Asset Valuation

The following are main reasons to value assets of your company:

- Sale of assets
- Use as collateral for a loan
- Contribution to a joint venture (JV)
- Updating book value of assets
- Insuring assets
- Part of business valuation

Only the first four reasons are related to obtaining finance

The purpose of asset valuation determines the audience:

- Banks/other lenders
- Business partners (JV partner or investor)
- Tax authorities
- Insurance companies
- Company management

ofcf7e/Page 7

Instructor's notes:

[This is an introductory slide about the purposes of asset valuation]

Note:

Among the 6 main reasons for asset valuation only 4 are related to obtaining finance, and they will be covered in the current presentation.

The audience for the valuation is shown to illustrate how many parties are involved and why accurate and fair asset valuation is important.

Specifics of valuation in almost all cases require attention to its legal aspects and to property rights in particular. The property rights strictly speaking do not affect the process of valuation itself (unless rights are unclear), but do affect the intended uses of valued assets.

Re-emphasize:

Value is not a single number.

Book value in the accounts of the enterprise is not the same as the fair market value

When Seeking to Obtain Finance, the Main Purpose of Asset Valuation is to Support Negotiations

Identification of source of financing ⇨ Asset Identification ⇨ Valuation of asset → **Negotiations**

Bargaining power is a key to success in the negotiations. Correct and professionally done asset valuation adds credibility and increases your bargaining power.

ofcf7e/Page 8

Instructor's notes:

While the components and logic of finance obtaining asset valuation process is self explanatory, the company's bargaining power needs some additional comments.

First, it is necessary to understand whether the negotiating parties are on equal footage or one of the parties has comparatively higher bargaining power. The following comments help to determine this:

•looking for a loan from a bank (especially in tight debt financing markets) puts a company into dependent position decreasing its bargaining power. In opposite the bank's bargaining power may be strengthen by the company's position. The bank's willingness to provide acceptable/good terms of financing may also depend on intended use of required financing.

•negotiating a joint venture puts parties on equal footage

•the company's bargaining power while selling assets also seems to be equal to the purchaser's one except for some unusual situations (e.g. either seller or buyer are monopolists, i.e. there is no competitive market)

In Asset Valuation Three Approaches Can Be Used

Cost Approach

Cost of purchasing a similar asset

1. Estimate the cost to replace the asset with a new asset
2. Estimate the amount of accrued depreciation (physical deterioration, functional and external obsolescence)
3. Deduct the cost of total accrued depreciation from the cost of new asset

Direct Sales Comparison Approach

A free market price for an asset of equal utility and quality

1. Obtain information on sales of similar/ same assets
2. Develop a comparative analysis to determine a single value indication or a range of values

Income Approach

Present value of future income and benefits

1. Estimate gross potential income
2. Estimate related expenses
3. Calculate net income
4. Discount net income to present worth

ofcf7e/Page 9

Instructor's notes:

Explaining each of the three valuation approaches, first, make sure that the audience understand the underlying rationale behind all the approaches:

•cost approach: cost of replacement of the asset with an asset of equal utility and quality

•direct sales comparison approach: price in a free market of an asset of equal utility and quality

•Income approach: present value of expected income derived from use of the asset

Then briefly explain the methodology of each approach.

Note that not all approaches are equally applicable due to insufficient information available, though the best way to value an asset is to use all three approaches and compare the results.

Use of any of the approaches requires high qualifications and it is recommended to contract professionals to deliver appraisal services.

Exercise 7.1: Asset Valuation

A. Data for which of the three approaches to asset valuation is the easiest to get?

- Cost Approach
- Income Approach
- Direct Sales Comparison Approach

B. Why are the property rights for the asset to be valued important?

- Affect choice of appropriate approach
- Restrict intended use of the asset

C. When negotiating to obtain financing a company has the lowest bargaining power with which counterparty?

- Bank loan
- Sale of the asset
- Forming Joint Venture

D. Which of the three approaches to asset valuation involves discounting technique?

- Cost Approach
- Income Approach
- Direct Sales Comparison Approach

ofcf7e/Page 10

Instructor's notes:

Exercise 7.1: Asset Valuation - Solution

A. Data for which of the three approaches to asset valuation is the easiest to get?	**Cost Approach** Income Approach Direct Sales Comparison Approach
B. Why are the property rights for the asset to be valued important?	Affects choice of appropriate approach **Restricts intended use of the asset**
C. When negotiating to obtain financing a company has the lowest bargaining power with which counterparty?	**Bank Loan** Sale of the asset Forming Joint Venture
D. Which of the three approaches to asset valuation involves discounting technique?	Cost Approach **Income Approach** Direct Sales Comparison Approach

ofcf7e/Page 11

Instructor's notes:

210

Business Valuation Determines the Market Value of Business Operations of a Going Concern

The value of a business is equal to the present worth of the future benefits of ownership:

- A rational buyer normally will invest in a company only if the present value of his future benefits of ownership are equal or greater to the purchase price
- Conversely, a rational seller normally will not sell if the present value of his expected benefits is more than the selling price

Value is not a single number:

- A company's value depends on each potential investor's assessment of the benefits and risks relating to a company. Generally, the valuation consultant's task is to determine the most likely or reasonable value estimate

Valuation is based on a specific point in time - the valuation date

The result of the business valuation will be the value of owner's equity

ofcf7e/Page 12

Instructor's notes:

Explain:

Buyer and seller may experience differing future benefits from ownership in the enterprise, depending on the circumstances and opportunity

For the purposes of negotiating with portfolio investors or pricing shares for a public issue, the equity value of the enterprise should be determined.

For negotiations with strategic investors, either equity or total invested capital, depending on the terms of the proposed transaction.

Value of equity is equal to value of total invested capital minus value of debt.

As the most likely transactions with strategic investors in Russia will involve acquisition of equity, we will concentrate in this seminar on the valuation of an enterprise's equity capital.

Discussion:

Ask several members of the audience:

1) if they know how much their company is worth (if they have some general idea or range)

2) if so, how do they measure the value of their company (what benchmarks/techniques do they use)?

311

The Market Value of Equity is What Business Valuation Attempts to Determine; This Should Not Be Confused With Other Definitions of Equity Value

Charter (nominal) capital - The charter capital of a privatized Russian enterprise is the original value of its share capital from privatization, plus any adjustments made based on asset revaluation. It has little to do with market value of shares	Share capital - Share capital is the charter capital plus any equity generated by past retained earnings, sale of shares over nominal value, etc. It is not equal to the current market value of equity
Share trading price - In developed capital markets, the current trading price per share multiplied by the number of shares should give the market value of equity. In Russia, however, the shares of few companies are actively, and openly traded, making this a poor indication of true value	Market value of equity - The current market value of all shares is the price at which the shares would change hands if sold in an open market between a willing buyer and seller, and reflects the market's view on the future earnings potential. The process of valuation attempts to determine this figure

ofcf7e/Page 13

Instructor's notes:

[This is a common area of confusion among many Russian enterprise managers. Some time may need to be spent explaining these differences]

Explain:

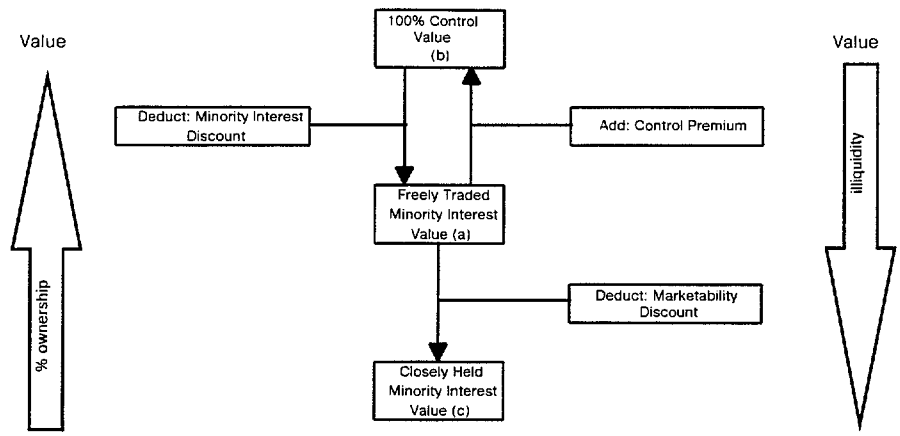
The market value of equity is what business valuation attempts to determine. This is the value at which the company should sell its shares to investors.

Other measures of equity value shown are misleading, especially in Russia, because

- they reflect historical value and past earnings - not the market's view of potential future earnings
- even the historical values they reflect are somewhat arbitrary
- the trading of most enterprises' shares is closely controlled and the price at which they trade is not a true market price

2/2

Shares of An Enterprise Will Have Different Values for Different Investors and Types of Transactions



(a) Typical starting point for most market based valuations - the value of 1 common share as if publicly traded

(b) Represents the value of the entire business if sold to one purchaser

(c) Represents value of an unlisted, non-controlling interest in a privately owned firm

ofcf7e/Page 14

Instructor's notes:

<u>**Explain**</u>:

<u>Control premium:</u>

Any minority or majority holding which influences decision making in the enterprise would put a premium on the value of the shares. If the control premium is 30-40% for a full acquisition, a 28% holding, for example, giving an investor ability to block major decisions, might justify a 10-20% premium.

<u>Marketability discount:</u>

Investors who do not exercise control over the company's management rely on liquid stock markets so they can realize a capital gain or sell an investment they no longer wish to hold. The shares of most Russian privatized enterprises are not freely traded; therefore a marketability discount (10-15%) would need to be applied. The more closely held the shares and the more controlled the trading of the shares, the larger the discount should be.

The more enterprise managers do to make its shares more easily tradable, the lower the discount.

Improvement in the trading infrastructure of the Russian market will bring increases in the traded values of shares of Russian enterprises.

Lack of Trading Infrastructure in Russian Capital Markets Negatively Affects Share Price, But Company Management Can Take Measures to Reduce the Impact

The lack of market infrastructure is a general problem for all Russian enterprises trying to sell shares. In addition, minority investors are concerned about potential violations of minority shareholder rights in Russia

Although capital market infrastructure development is beyond the control of enterprise management, enterprise directors can make a significant contribution to investors' confidence by undertaking to:

- Make every effort to have the enterprises' shares admitted for trading on the systems operated by the Professional Association of Securities Market Participants, and on one or more stock exchanges
- Comply with all applicable regulations which are issued by the Federal Commission on Securities and Stock Markets
- Treat all shareholders equally; take into account the interests of minority shareholders, ensure that all shareholders entitled to dividends receive any dividends declared, and conduct general and extraordinary meetings of shareholders in a fair, open and orderly manner so as to enable shareholders to exercise their rights
- Contract an independent entity to keep the shareholder register, and ensure that the maintenance of the shareholder register complies with applicable legislation

ofcf7e/Page 15

Instructor's notes:

Illustration:

From Central European Economic Review, April 1996, referring to a March research report by investment bank Morgan Stanley:

"So what should prospective bargain hunters buy? The report recommends LukOil, which it praises as 'one of the standard bearers for corporate governance in Russia'."

214

There are Three Main Approaches to Business Valuation

Any Business Valuation Must Consider:		*The 3 Main Business Valuation Approaches:*
1. Economic conditions **2. Industry conditions** **3. Company specifics** • The nature and history of the business • The economic outlook for the industry • The financial condition of the business • Historical and future earnings, cash flow, and net asset value (including goodwill and other intangibles) • Likely shareholding structure, past sales of shares	⇒	• Discounted cash flow method • Asset-based (replacement cost) method • Market comparison based methods – Capital markets – Trade transactions

ofcf7e/Page 16

Instructor's notes:

Explain:

Each valuation method has advantages and disadvantages, as will be discussed in a few minutes.

Ideally, an enterprise should be valued using each of the three approaches, which can be compared to give a range of values for the equity of the enterprise.

Asset Based Method: Equity Value = Market Value of Assets - Market Value of Liabilities

The asset based business valuation method has the following steps:

- Each category of the enterprise's assets (tangible and intangible) and liabilities are valued separately
- Assets are valued on the principle of "in place", that is in terms of their contribution to the business as a going concern, rather than their value if disposed of piecemeal
- In valuing liabilities, care should be taken to search for any liabilities not appearing on the balance sheet - "contingent liabilities"

This valuation technique focuses on the value of those assets used effectively in the ongoing business operations. If your company has substantial assets which are not used effectively, then it usually provides a lower value. In this case a fixed asset valuation would provide a higher value

ofcf7e/Page 17

Instructor's notes:

Explain:

For the purpose of the rest of our discussion, we will assume that the enterprise to be valued is a going concern, and we will therefore used depreciated replacement cost.

It should be kept in mind, however, that in Russia this is very likely to give an inflated value of the enterprise, especially if many assets are not contributing to the ongoing business.

Many Russian plants are larger than necessary for efficient operation in a market economy - care must be taken to discount values accordingly from replacement value of these assets.

There Are Two Types of Market Comparison Based Business Valuations

The two types of comparative companies valuation are:

1) ***Capital markets valuation** reflects value of shares by comparison with prices of shares traded in a stock market*
   - Takes share price of similar publicly traded companies and calculate ratios of the share price to earnings, cash flow, or assets, and applies these multiples to the earnings, cash flow, and assets of the company to be valued, to arrive at a notional market value
   - Adjusts ratios for differences between these companies and the business being valued, discounting for any working capital deficit, country risk (political risk, expropriation risk, etc.), illiquidity of shares, or liability risks
2) ***Trade transactions valuation** is based on the price paid for similar companies when sold to another company or investor*
   - Takes the price paid per share for a similar publicly traded company acquired in a trade transaction and calculate ratios of the share price to earnings, cash flow, or assets, and applies these multiples to the earnings, cash flow, and assets of the company to be valued, to arrive at a notional market value
   - Again, discounts for any working capital deficit and for country risk, etc.

Instructor's notes:

Explain:

Capital market valuation

- gives a value based on similar publicly traded companies in efficient stock markets. Ratios compare stock market values of shares to certain accounting measures.
- represents the value of one common share as if publicly traded

Trade transactions valuation

- represents the value of a majority acquisition, and therefore includes a control premium over the value of one share publicly traded.
- adjustments would need to be made for the purpose of a public share issue - deducting a control premium (30-40%), and subtracting the costs of the sale (for example, fees paid to intermediaries - typically around 3% for a larger company; more for a smaller company).

Market Comparison Based Business Valuations Are Not Very Useful Methods in the Russian Context

- Difficult to find truly comparable companies. Few Russian enterprises compete in the same markets as their western counterparts, and financial structures and accounting systems are likely to be very different

- Most multiples are based on recent and current earnings/cash, etc. Use of these multiples would give a very low value to most Russian enterprises in the present recession; the value of most Russian enterprises lies in their future recovery potential

- Need to adjust ratios for differences between Russian accounts and IAS accounts for comparison

ofcf7e/Page 19

Instructor's notes:

218

Discounted Cash Flow (DCF) Business Valuation Is the Most Appropriate for Many Russian Enterprises

- The concept of discounted cash flow (DCF) is to estimate the benefits available to the investor after paying all expenses related to operating the business. It is a better method than accounting profits, since accounting profits can be manipulated through different accounting practices and, particularly in Russia, distorted by tax rules
- Positive cash flow is the source of money for payment of dividends, regardless of whether or not a company pays out 100% of its free cash flow in the form of dividends each year; cash retained in the business will contribute to capital growth and dividends in the future
- Future cash flows are discounted back to their present value equivalent using a discount rate that matches the investor's required rate of return. The investor's required rate of return is based on his analysis of the risk of investing in the business and in the risk of actually receiving the expected future cash flows

DCF business valuation → . . .is the only method which explicitly takes into account all important factors - the stream of benefits the owner/investor expects to receive in the future, the timing of receipt of those benefits, and the risk borne by the owner/investor

ofcf7e/Page 20

Instructor's notes:

Re-emphasize:

The other two business valuation methods have the following serious drawbacks:

- Market comparison business valuation is not applicable because of lack of information

- Asset based (replacement cost) business valuation does not always reflect the full potential of a well operated business.

219

DCF Business Valuation Is A Two-Step Process

Forecasting

- To carry out an earnings based valuation, the following items must be analyzed and forecast several years into the future:
  - Revenues (influenced by competition, production capacity , inflation, etc..)
  - Expenses (fixed and variable costs, inflation, cost of borrowing, etc..)
  - Investment (working capital requirements, capital expenditure, etc..)
  - Residual value (value of business after the forecast period)
- This should produce forecasts of cash flow for a number of years, ideally in nominal terms because inflation affects components of the forecast in different ways

Discounting

- The value of the company is calculated by discounting the forecast post-tax cash flows back to a present value. This rate will be equal to investors' required rate of return

ofcf7e/Page21

Instructor's notes:

Explain:

The procedure for cash flow forecasting is similar to that described earlier for projecting project cash flows. The difference is that, when projecting project cash flows, only incremental inflows and outflows for that project should be taken into account. When valuing business operations of the entire company, cash flows for the entire enterprise must be forecasted.

Based on conversations with investment funds, investors expect rates of return in the Russian market of 30-50%.

Who Performs Valuations and Why?

Not enterprise managers

- The motivation is to price too high

Not banks

- The motivation is to price too low

Therefore, valuation is almost always performed by independent appraisers who:

- Better know the market
- Theoretically have no motivation to over or under price assets/business operations
- Apply standard methodologies
- Are experienced in this area
- Lend credibility to the valuation (their reputation is on the line)
- Some lenders/investors insist on a valuation performed by an internationally respected firm, in order to ensure independence

ofcf7e/Page 22

Instructor's notes:

Explain:

Valuation is a complicated exercise which must take into account :

- control premiums/discounts based on the type of transaction
- required rates of return of various types of investors in the current market
- discount factors related to specific types of risk (political, economic, business, liquidity, etc,)
- comparison of the results of the three methods and assessment of their relative appropriateness for the company's position and the proposed transaction

Although business valuation is usually performed by professional specialists, company management need to have an understanding of valuation to know what is appropriate in any given circumstance. Understanding how the valuation was carried out will help in negotiations.

How Do You Use the Results of Valuation in Negotiations with Potential Investors?

Portfolio investors

- The range of values determined through business valuation provides a starting point in negotiating what percentage ownership of the enterprise should be offered for a given amount of investment. From the valuation procedure company management will have justification for its position
- Most likely, the potential investor will have come up with a range of figures for this purpose themselves

Strategic investors

- The same situation holds with strategic investors, but in addition, company management might wish to consider the results of asset valuation separately. The value of assets is likely to be higher than the business valuation for Russian enterprises. To get a better price for the deal, management can refer to its asset value numbers and negotiate down towards the business valuation figure
- In this case, the asset valuation can be considered a maximum value of the enterprise and the business valuation a minimum value of the enterprise

Instructor's notes:

How do you use the results of valuation to set share price in a public issue?

The business valuation range of values provide a starting point for pricing the shares

⇩

Once documentation has been prepared for the issue, the enterprise should begin talks with portfolio investors in an effort to pre-sell a portion of the issue. Out of these discussions enterprise management should be able to determine if the initial price is too high or too low. Again, this is a process of negotiation

If a substantial portion of the issue is presold at a certain price, it is likely that that other investors (especially smaller ones) will be influenced by the already demonstrated interest of in the issue, and will be likely to "jump on the band wagon" and buy at the same price during the offer period

⇩

As share prices in the Russian market are highly volatile, the price may need to be adjusted several times up to the offer period.

⇩

Issue Share Price

ofcf7e/Page 24

Instructor's notes:

Exercise 7.2: Sources and Uses of Company Valuation Information

The following are Yes - No questions. Circle the appropriate answer:

A. Can you determine the market value of a privatized Russian enterprise from the balance sheet?	*Yes*	*No*
B. Do you need a business valuation to obtain debt financing?	*Yes*	*No*
C. Is the share value equal for different investors?	*Yes*	*No*

ofcf7e/Page 25

Instructor's notes:

Exercise:

Tell the audience to turn to this page in their slide pack and test themselves by circling the correct answer for each question.

Emphasize

Business valuation is not a simple linear process. Not all available information can be used for it, though the information used will affect the result.

Answers are given on the next slide.

Exercise 7.2: Sources and Uses of Company Valuation Information - Solution

A. Can you determine the market value of a privatized Russian enterprise from the balance sheet?	*Yes*	$\boxed{\textit{No}}$
B. Do you need a business valuation to get debt financing?	*Yes*	$\boxed{\textit{No}}$
C. Is the share value equal for different investors?	*Yes*	$\boxed{\textit{No}}$

ofcf7e/Page 26

Instructor's notes:

Explain:

If some participants marked "Yes" for question B -

The correct answer is "No". An asset valuation may be used to value assets for collateral to get a loan, but a business valuation is not needed.

Exercise 7.3: Highlights of Company Valuation

What should be taken into consideration under the following methods (circle appropriate answer):

A. Earnings based methods	*Profit declared in P&L statement*
	Stream and timing of future benefits
B. Asset based methods	*Assets book value*
	Assets contribution to ongoing business
C. Market based methods	*Price of shares of similar enterprises traded in a stock market*
	Face value of shares upon privatization

ofcf7e/Page 27

Instructor's notes:

Exercise:

Tell the audience to turn to this page in their slide pack and test themselves by circling the correct answer for each question.

Emphasize

Business valuation is not a simple linear process. Different methods emphasize different aspects of the business and thus require different information.

Answers are given on the next slide.

Exercise 7.3: Highlights of Company Valuation - Solution

Under the following methods take into consideration:

A. Earnings based methods	*Profit declared in P&L statement*
	$\boxed{\textit{Stream and timing of future benefits}}$
B. Asset based methods	*Assets book value*
	$\boxed{\textit{Assets contribution to ongoing business}}$
C. Market based methods	$\boxed{\textit{Price of shares of similar enterprises traded in a stock market}}$
	Face value of shares upon privatization

ofcf7e/Page 28

Instructor's notes:

227

Seminar Agenda

Session 1:	Finance Overview
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Session 8:	**Summary**

ofcf8e/Page 1

Instructor's notes:

Projects should be selected on their merits as to how much value they add to the firm. This section will provide several tools for evaluating projects and explain why net present value is the best of these tools.

Ask participants if they understood the homework. Ask them if it was difficult or easy? Do they see ways to apply this to their companies?

What Have We Covered?

- What is corporate finance?
- What is the time value of money?
- When do you need short term vs. long term financing?
- How do you select projects for financing?
  - Strategic assessment
  - Financial evaluation
    - Cash flow forecasting
    - Evaluation using NPV, IRR, Cash Payback
- What are the sources of capital for a Russian firm?
  - Short-term finance
  - Long-term finance
- How do you approach investors?
- How do you prepare a business plan, investment memorandum and issue prospectus?
- How do you value your company?

ofcf8e/Page 2

Instructor's notes:

Review: What is Corporate Finance?

- Corporate finance deals with a company's liabilities and equity
- Corporate finance covers short and long-term finance, internal and external
- Capital is the lifeblood of business
- Financial managers try to minimize the cost of obtaining needed finance
- After internal resources are exhausted, firms can obtain financing from external sources...
- ... provided:
  - The project makes strategic sense
  - The project makes financial sense

ofcf8e/Page 3

Instructor's notes:

Emphasize:

The type of financing required depends upon its intended use.

Internal financing is always less expensive than external financing Search for internal sources first.

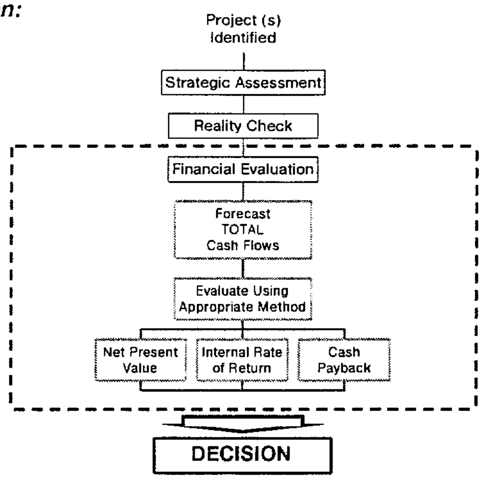
Capital is necessary to support current operations, to expand or modernize existing operations, to undertake new projects. Capital investment should therefore be a continuous operation of the enterprise under normal business conditions.

Financing has a cost, usually a significant cost. The financial director is responsible for minimizing this cost, but the whole executive committee must support him in that task.

External sources of financing are accessible ONLY if the project in question makes strategic AND financial sense.

Effective Project Selection Requires a System for Project Evaluation

The best system includes a strategic evaluation, a "reality check" and a financial evaluation:



ofcf8e/Page 4

Instructor's notes:

We will first discuss strategic valuation, then we will go through cash flow forecasting, and finally, we will discuss net present value, internal rate of return and cash payback - 3 methods for financial evaluation.

Sources of Short-Term Finance

Options for external short-term finance for Russian enterprises include:

- Trade credit
- Tolling
- Bank finance for working capital
- Mutual settlement/offset
- Commercial paper/ notes
- Sale or discounting of accounts receivable (factoring)
- Short term operating leases

ofcf8e/Page 5

Instructor's notes:

Emphasize:

There are a number of sources of short-term finance. A lot of companies are unaware of the resources that they can free up to make available for short-term financing. Improved working capital management can have significant effects on freeing resources.

Additional Information

Improved working capital management concerns inventory control, procurement, receivables and payables control, sales and invoicing processes.

Trade credits are credits extended by suppliers in the normal course of business. These are recorded as accounts payable, not as debt.

Tolling is the process of receiving raw materials (at no cost) from a supplier, processing the materials, and then returning the processed goods to the supplier. The processor may be paid in cash or a portion of the processed goods. This process is also called give-and-take.

In the mutual offset chain, receiving goods from a supplier before shipping goods to another party equates to short-term borrowing.

Commercial paper of an enterprise is often used as promissory notes in the mutual offset chain.

Factoring and leasing are less prevalent in Russia.

Sources of Long-Term Finance

The options for long term financing can be divided into:

- **Currently used sources of long-term financing**
  - Russian banks
  - Foreign banks
  - Portfolio investors - private funds
  - Portfolio investors - "aid" funds
  - Strategic investors

- **Other less frequent but up-and-coming sources of long-term financing**
  - Public issues of shares/rights (Russian and foreign, including ADR/GDRs)
  - Bonds
  - Convertible bonds
  - Leasing

ofcf8e/Page 6

Instructor's notes:

Additional Information

Foreign banks are becoming more prevalent in Russia. They may provide loans for less than Russian banks, but their requirements may be more stringent.

Portfolio investors include investment funds, venture capital funds, pension funds, and insurance funds. They are generally seeking a mix of capital gains and income. They may specialize by industry. Generally they are not interested in controlling interest, although they may seek to place a representative on the board.

"Aid" funds provide a range of financing, and may be easier to approach than private funds.

Strategic investors are generally interested in long-term equity investments. They also seek a significant share of control within the project (or company).

Less frequent alternatives (although growing in popularity) are public share issues, bonds, and lease financing.

Approaching Investors

Prepare <u>before</u> talking to a bank or an equity investor

- Select a good project
- Consider the investor's/ banker's information needs
- Appoint an advisor
- Prepare internal due diligence

Select the right source of finance

- Invest in a capital search
- Select the lowest-cost source of capital
- Negotiate favorable terms

Continue to work after you have reached an agreement

- Meet Russian statutory requirements
- Take care of taxes and ministry approvals

ofcf8e/Page 7

Instructor's notes:

<u>Emphasize:</u>

Capital investment should be a continuous process, therefore you should always be involved in evaluating projects and finding investors.

Investors/banks require detailed information to make their decisions. Refer to Sections 5 & 6 for the details on this information. Enterprises should prepare business plans, investment memoranda, and issue prospectus depending on the type of financing they are seeking.

Financial advisors can be very helpful in the preparing for and approaching investors.

One of the major responsibilities of a financial manager is to keep the cost of capital for the enterprise to a minimum. Selection of the right financing is critical to the enterprise's success.

Once financing has been secured, maintain relations with the investor, and seek to meet all the terms of the agreement. If you are successful, and you let it be known, then it will be easier to find further investors for your next projects (if they make strategic and financial sense).

Preparing a Business Plan, Investment Memorandum, and Issue Prospectus

- Business plan, investment memorandum and prospectus are all ways of communicating information about a company to a particular target audience
- Business plan is typically an internal document, given to banks or business partners
- Investment memorandum is used for private placements and bank loans
- Prospectus is a widely distributed document covered by several laws on investing
- All of these documents take time to prepare and contain a lot of information
- Some investors, such as IFC or EBRD have a specific formats for business plans
- A financial advisor, consultant, accountant, and lawyer can provide assistance to make your document successful

ofcf8e/Page 8

Instructor's notes:

Refer to Section 6 of the seminar for the details on preparing business plans, investment memoranda, and issue prospectus.

Valuing Your Company

- There are two types of valuation: asset valuation and business valuation
  - Asset valuation for the purposes of obtaining finance is used in negotiations with potential purchasers of assets and lenders
    - There are three approaches to asset valuation: cost approach, direct sales comparison approach, and income approach
  - Business valuation is used for negotiations with potential portfolio or strategic investors and for pricing shares in a public issue
    - There are three approaches to business valuation: discounted cash flow (DCF), asset based business valuation, and market comparison based business valuation
  - Equity value = value of the firm - current value of liabilities
    - Equity value is different from charter capital, share capital or share trading price
- Valuation is almost always performed by independent appraisers who are experienced, better know the market, apply standard methodologies, and lend credibility to the valuation

ofcf8e/Page 9

Instructor's notes:

Refer to section 7 of the seminar, "Company Valuation▫ for discussion of the issues affecting equity value.

<u>Emphasize</u>

Value is relative: ultimately either assets or the business itself (or its equity) is only going to be worth what someone is prepared to pay for it, at a given time. This value will differ between purchasers and on the circumstances of the sale.

23 6

Summary of Main Points

An Enterprise:

- is competing both in its industry for profits, as well as across industry sectors for capital to fund future development projects
- must be realistic about what it takes and how much it costs to obtain financing at the present time in Russia
- should plan a financial strategy to meet its short term and long term needs
- needs to manage internal sources of capital and be certain of the value (strategic and financial) of projects for which it seeks external financing
- should be aware of different sources of financing and determine which would be appropriate for its needs
- must spend the necessary time and effort in preparation for approaching these sources
- should make an effort to continue a good relationship with lenders/investors after the deal if it wants to have more options for future financing

ofcf8e/Page 10

Instructor's notes:

[This concludes the lecture part of the seminar. Next we will move on to solutions of the homework problems. Solution for Problem 1 begins on the next slide.]

Homework Assignment

Essentials of Corporate Finance and Obtaining Finance

ofcf9e/Page 1

Instructor's notes:

Homework Problem 1: AO Bicycle Company

Problem:

Assume it is August, and AC Bicycle Company must buy additional raw materials for added production in order to have bicycles in stores before the Christmas buying season. The company needs to acquire RUR 1 billion in additional raw materials, but has less than RUR 200 million in cash and bank deposits

The company's balance sheet is shown on the following slide

Required:

Develop a plan for ensuring that AOBC can purchase the additional raw materials to produce bicycles to meet the Christmas demand

ofcf9e/Page 2

Instructor's notes:

Homework Problem 1: AO Bicycle Company - Balance Sheet

AO Bicycle Company
Balance Sheet as of 01/08/96
(rubles 000s)

Assets		*Liabilities and Equity*	
Long term assets	***1,791,000***	***Equity***	***1,225,700***
Intangibles	-		
Fixed assets	1,791,000	***Liabilities***	***3,913,300***
Short-term assets	***3,348,000***	Long-term debt	3,500,000
Inventories	2,423,000		
Raw materials	1,000,000	Short-term liabilities	413,300
Work in process	467,000	Wages and taxes payable	260,000
Finished goods	956,000	Payables to suppliers	70,000
Receivables	800,000	Debt due	83,300
Cash	125,000		
Total assets	***5,139,000***	***Total Liabilities and Equity***	***5,139,000***

ofcf9e/Page 3

Instructor's notes:

340

Homework Problem 1: AO Bicycle Company - Solution

First set up an algorithm for solution:

- Financing is required for raw materials, i.e. working capital
- Added production project is for a period of less than a year, thus sources of short-term financing are to be used
- Total amount required is RUR 875 million (1 billion less 125 million)
- Analysis of the balance sheet shows:
  - Receivables are more than eleven times higher than payables
  - Stock of finished goods is high
  - Work in process is high

Then develop a plan to get financing for extra raw materials to meet the demand

- Match receivables and payables by more aggressively collecting receivables and stretching payables
  - An achievable maximum could be as big as RUR 730 million
- Decrease level of finished goods by offering discount for cash purchases
- Sell receivables or offer discounts for early payments
- Short term bank loan is the ultimate option but is the most expensive source

ofcf9e/Page 4

Instructor's notes:

__Explain__:

This homework assignment sets out a common problem for many companies, especially when demand is seasonal, but there is a lag between ordering / paying for raw materials and receiving cash for goods sold.

Homework Problem 1: AO Bicycle Company - Solution (continued)

AO Bicycle Company
Balance Sheet
as of 01/08/96
(rubles 000's)

We may find significant sources of cash on the balance sheet to avoid debt.

(shaded areas are sources of cash)

Assets		Liabilities and Equity	
Long term assets	1,791,000	Equity	1,225,700
Intangibles	-		
Fixed assets	1,791,000	Liabilities	3,913,300
Short-term assets	3,348,000	Long-term debt	3,500,000
Inventories	2,423,000		
Raw materials	1,000,000	Short-term liabilities	413,300
Work in process	467,000	Wages and taxes payable	260,000
Finished goods	956,000	Payable to suppliers	70,000
Receivables	800,000	Debt due	83,300
Cash	125,000		
Total assets	**5,139,000**	**Total Liabilities and Equity**	**5,139,000**

ofcf9e/Page 5

Instructor's notes:

Explain:

Potential sources of cash include:

1. Extend payables - the company has little short-term liabilities. It may be able to acquire the goods on credit or extend other payables to free up cash for paying for the raw materials.

2. Sell finished product - AOBC has 950 million rubles of finished product on its balance sheet. These may be sold or may reduce the production requirement for the Christmas season.

3. Sell receivables - AOBC has 800 million rubles of receivables on its balance sheet. These may be factored. Alternatively, it can tighten credit requirements or provide discounts for buyers who pay earlier.

4. Take on short-term debt - AOBC can get a bank loan for 4-5 months until it receives payment for products sold over the Christmas season. This should be the last choice as the company has several other options to free up the cash needed.

Homework Problem 2: AOBC

Problem:

You are the Financial Director for AOBC, and you have determined that acquiring new painting equipment will save the company significant cash over the next five years. You estimate that the cost savings are worth 5 billion rubles in present value terms. The new equipment will cost you 1.5 billion rubles and will replace equipment with a salvage value of 300 million rubles. Unfortunately, you have only 98 million rubles in cash and bank deposits

Your current balance sheet is shown on the following slide

Required:

Develop a plan to finance the purchase of the new painting equipment

ofcf9e/Page 19

Instructor's notes:

Homework Problem 2: AOBC - Painting Equipment

AO Bicycle Company
Balance Sheet as of 01/08/96
(Rubles 000s)

Assets		*Liabilities and Equity*	
Long term asset	*1,791,000*	*Equity*	*4,427,700*
Intangibles	-		
Fixed assets	1,791,000	*Liabilities*	*913,300*
Short-term assets	*3,550,000*	Long-term debt	500,000
Inventories	2,252,000		
Raw materials	435,000	Short-term liabilities	413,300
Work in process	467,000	Wages and taxes payable	260,000
Finished goods	1,350,000	Payables to suppliers	70,000
Receivables	1,200,000	Debt due	83,300
Cash	98,000		
Total assets	*5,341,000*	*Total Liabilities and Equity*	*5,341,000*

ofcf9e/Page 20

Instructor's notes:

244

Homework Problem 2: AOBC - Solution

First set up an algorithm for solution:

- Financing is required for equipment, i.e. capital investment
- The project is for a period more than one year, thus sources of long term financing are to be used
- Before recurring to external sources, assess what capital can be generated internally
- Assess availability of long term financing from all sources (debt and equity)
- Analysis of the balance sheet shows
  - Inventory of raw materials is already RUR 1 b
  - Receivables are unreasonably high and exceed payables more than 17 times
  - Stock of finished goods is high
  - Inventories are extremely high
  - Work in process is high (mind the production cycle and the process used)

ofcf9e/Page 21

Instructor's notes:

Note:

This problem deals with long-term finance, but brings in other aspects of finding financing for a project which has been deemed to have value. There are several ways of structuring a financing package, but it is important first to look at internal sources of cash.

Explain:

There are several sources of cash right on the company's balance sheet:

· 300 million rubles from selling the old equipment (less taxes, of course)

· 1.2 billion rubles of receivables which should be realized more efficiently

· 1.35 billion rubles of finished goods in inventory. This amount may be seasonal, but let's assume it is not. What does that say about the company's marketing and planning? That should be a sign to management that they have some other fundamental problems to deal with in addition to controlling costs. Remember: being a low cost producer of goods nobody buys is not profitable. Some of this inventory is bound to be obsolete. Instead of waiting for someone to offer a good price for this inventory (an increasingly unlikely possibility), it is better to sell now at a heavy discount in order to raise funds for the project.

Homework Problem 2: AOBC - Solution (continued)

Develop a plan to get financing for new painting equipment

- Sale of old equipment to be replaced - RUR 300 m
- Sell any obsolete finished goods at a heavy discount
  - may be able to raise RUR 200 m
- Decrease non-obsolete finished goods by offering a discount for cash purchases
- Sell receivables or offer discounts for early payments
- Match receivables and payable by more aggressively collecting receivables and stretching payables
  - an achievable maximum might be about RUR 1 b
- The balance of capital required may be obtained through bank loans or sale of new shares.
  - For this size project, the best source of long term funds will probably be "aid" funds

ofcf9e/Page 22

Instructor's notes:

<u>Note</u>:

If internal sources do not raise enough to acquire the equipment, debt should be considered before equity. Reasons to consider debt first:

1. No loss of control - debt does not constitute ownership in a company, so the company does not have to give up strategic control of the boards of directors.

2. Lower cost - debt generally has a lower cost than equity. This is because it is of a lower risk than equity, which is subordinated to debt.

Capital Investment Calculation

AO Bicycle Company

Capital Investment	Initial	Year 1	Year 2	Year 3	Year 4	Year 5	Total	Depreciable basis
Land								
Buildings								
Equipment	2,000							2,000
Installation costs	100							
Working capital	1,863							
Other								
Total Investment	3,963	0	0	0	0	0	3,963	

Cash Flow Forecast

AO Bicycle Company

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Sales volume (in units)		20000	23000	25000	25000	25000
Inflation for the period	35%	20%	15%	12%	10%	10%
Sales price	0.40	0.54	0.65	0.75	0.83	0.92
Sales revenue		10800	14904	18630	20866	22952
Royalty payments		-432	-596	-745	-835	-918
Raw materials		-2160	-2981	-3726	-4173	-4590
Electricity		-864	-1192	-1490	-1669	-1836
Gas and water		-216	-298	-373	-417	-459
Spare parts		-2700	-3726	-4658	-5216	-5738
Depreciation-Building						
Depreciation-Equipment		-400	-400	-400	-400	-400
Wages		-1080	-1490	-1863	-2087	-2295
Overhead expenses						
Earnings before taxes		2,948	4,220	5,375	6,068	6,715
Taxes		-1032	-1477	-1881	-2124	-2350
Earnings after taxes		1916	2743	3494	3944	4365
Add back depreciation		400	400	400	400	400
Project cash flows		2316	3143	3894	4344	4765
Working capital needs	-1863	-298	-308	-321	-359	-396
Capital investment	-2100					
Salvage value						
Net Cash Flows	-3963	2018	2835	3573	3985	4369

Net Present Value Calculation

AO Bicycle Company

Discount Rate: 80%

Year	Net Cash Flow *A*	Discount Factor *B*	Discounted Cash Flow *C*
1	2018	0.556	1121
2	2835	0.309	875
3	3573	0.171	613
4	3985	0.095	380
5	4369	0.053	231
Add up: Present Value			3220
Subtract: Initial Investment			3963
Net Present Value			-743

549

Discount Factor Table

Period	Discount Rate						
	10%	15%	20%	25%	30%	35%	40%
0	1.000	1.000	1.000	1.000	1.000	1.000	1.000
1	0.909	0.870	0.833	0.800	0.769	0.741	0.714
2	0.826	0.756	0.694	0.640	0.592	0.549	0.510
3	0.751	0.658	0.579	0.512	0.455	0.406	0.364
4	0.683	0.572	0.482	0.410	0.350	0.301	0.260
5	0.621	0.497	0.402	0.328	0.269	0.223	0.186
6	0.564	0.432	0.335	0.262	0.207	0.165	0.133
7	0.513	0.376	0.279	0.210	0.159	0.122	0.095
8	0.467	0.327	0.233	0.168	0.123	0.091	0.068
9	0.424	0.284	0.194	0.134	0.094	0.067	0.048
10	0.386	0.247	0.162	0.107	0.073	0.050	0.035

Period	Discount Rate						
	45%	50%	55%	60%	65%	70%	75%
0	1.000	1.000	1.000	1.000	1.000	1.000	1.000
1	0.690	0.667	0.645	0.625	0.606	0.588	0.571
2	0.476	0.444	0.416	0.391	0.367	0.346	0.327
3	0.328	0.296	0.269	0.244	0.223	0.204	0.187
4	0.226	0.198	0.173	0.153	0.135	0.120	0.107
5	0.156	0.132	0.112	0.095	0.082	0.070	0.061
6	0.108	0.088	0.072	0.060	0.050	0.041	0.035
7	0.074	0.059	0.047	0.037	0.030	0.024	0.020
8	0.051	0.039	0.030	0.023	0.018	0.014	0.011
9	0.035	0.026	0.019	0.015	0.011	0.008	0.006
10	0.024	0.017	0.012	0.009	0.007	0.005	0.004

Period	Discount Rate				
	80%	85%	90%	95%	100%
0	1.000	1.000	1.000	1.000	1.000
1	0.556	0.541	0.526	0.513	0.500
2	0.309	0.292	0.277	0.263	0.250
3	0.171	0.158	0.146	0.135	0.125
4	0.095	0.085	0.077	0.069	0.063
5	0.053	0.046	0.040	0.035	0.031
6	0.029	0.025	0.021	0.018	0.016
7	0.016	0.013	0.011	0.009	0.008
8	0.009	0.007	0.006	0.005	0.004
9	0.005	0.004	0.003	0.002	0.002
10	0.003	0.002	0.002	0.001	0.001

250

Homework Problem 3: AOBC and Bombino Bicycles

Problem:

AO Bicycle Company is a Russian manufacturer of bicycles for adults and children of different ages. AO Bicycle Company has experienced serious problems with its "Raketa" model, their bicycle for children 5-8 years old. Sales of this model have declined 70% over the last two years

Results of the marketing study conducted by the company's sales & marketing department clearly demonstrated that AO Bicycle Company is facing increasing competition and losing its market share in the 5-8 age segment to imported bicycles. Customers prefer imported bicycles because of their better design and quality. AO Bicycle Company realized that it needed a new model and a complete line of modern equipment to win back market share

The Board of Directors of AO Bicycle Company now has to make a decision on the project on the following slide

Required:

Calculate the net present value of this project and make recommendations to the Board of Directors

ofcf9e/Page6

Instructor's notes:

Homework Problem 3: AOBC and Bombino Bicycles - Proposal

Facts

AO Bicycle Company started negotiations with a potential strategic investor, Bombino Bicycles, an Italian manufacturer of bicycles for children. Bombino Bicycles is considering investing in AO Bicycle Company by offering to pay for half the cost of new equipment that AO would need to produce a new model "Starbike", which was developed by Bombino. Furthermore, Bombino Bicycles offered AO Bicycle Company its design and manufacturing technology of "Starbike" for a 5-year period for a royalty equal to 4% of annual sales.

If AO Bicycle Company enters into a partnership with Bombino, it will then discontinue its "Raketa" model and start production of a new bicycle based on Italian design and technology. In this case, the 100 million rubles spent last year on modernization of metal processing equipment for "Raketa" will be lost.

The AO bicycle company will need to pay $400,000 for its half of the new equipment and would have to incur installation costs (a one-time expense) of 100 million rubles. AO Bicycle Company can locate this new workshop in a building owned by the company. The building is in good condition and is worth 100 million rubles. The company has no alternative use for this building.

The company will use both existing and additional workers to operate the machinery in a new workshop. Maintenance and repair of this new equipment will be carried out by the company's existing machinery repair workshop. Total payroll of employees in the machinery repair workshop is 5 million rubles per month.

ofcf9e/Page 7

Instructor's notes:

35 2

Homework Problem 3: AOBC and Bombino Bicycles - Forecasted Sales and Costs

AO Bicycle Company plans to manufacture 20,000 bicycles in the first year of its operations, 23,000 in the second year and 25,000 bicycles per year in years 3 to 5. The estimated sales price is 400,000 rubles per bicycle, which will have to be adjusted in accordance with inflation

Forecasted incremental costs (as % of sales):

Raw materials	20%
Spare parts	25%
Electricity	8%
Gas and water	2%
Additional worker salaries	10%
Total	65%

ofcf9e/Page 8

Instructor's notes:

Homework Problem 3: AOBC and Bombino Bicycles - Assumptions

Please take the following assumptions into account when calculating the NPV of the project:

- After assessing all project risks you have determined that the appropriate discount rate for all periods is 80%
- Depreciation should be calculated on a straight-line basis over a 5-year period. This equipment will be carried on company books at the historical cost, no reevaluations are expected. Assume that the equipment will have no residual value after 5 years
- The terms of trade will be set so that, taking into account increases in sales and inflation, a realistic forecast of working capital needs is:

year 0	*RUR 1,863m*
year 1	*RUR 298m*
year 2	*RUR 308m*
year 3	*RUR 321m*
year 4	*RUR 359m*
year 5	*RUR 396m*

ofcf9e/Page 9

Instructor's notes:

Homework Problem 3: AOBC and Bombino Bicycles - Additional Assumptions

Additional assumptions:

· Inflation forecast:

year 1	35%
year 2	20%
year 3	15%
year 4	12%
year 5	10%

· Assume that inflation will equally affect the costs of inputs and sales prices

· Current exchange rate: $1 = 5,000 rubles

· Tax rate is 35% and it is not expected to change over a 5 year period

ofcf9e/Page 10

Instructor's notes:

Homework Problem 3: AOBC and Bombino Bicycles - Solution

The project NPV calculation requires determining net cash flow

Identify relevant cash flows and state clearly all assumptions to be used in the cash flow model

The following are not incremental costs, and are therefore irrelevant:

- Metal processing equipment modernization is a sunk cost and is not included into the model. (RUR 100 m sunk cost)
- Use of the existing production building is not a cash outlay and is not included into the model. (Building worth RUR 100 m is irrelevant)
- The payroll for the existing workforce is not relevant for the cash flow, but the payroll for additional workers needed will be relevant

ofcf9e/Page 11

Instructor's notes:

Explain:

More important than calculating the NPV is getting the cash flow projections right and discerning between incremental cash flows and those that are irrelevant. Clearly, not all of the information in the case is relevant.

[This slide shows which cash flows are irrelevant.]

[The following slide breaks down relevant cash flows.]

256

Homework Problem 3: AOBC and Bombino Bicycles - Solution (continued)

Relevant cash flows are divided into two groups: outflow and inflows. They are annual/periodic and initial/one time.

- Initial cash outflows are:
  - Purchase of new equipment: RUR 2 b ($400,000 x (exchange rate of $1 = RUR 5,000))
    - Straight-line depreciation for 5 years with no residual value
  - Installation costs: RUR 100 m
- Annual cash inflows are proceeds from sales:
  - 20,000 units (1st year), 23,000 units (2nd year) and 25,000 (years 3-5)
  - Initial price RUR 400,000 (to be adjusted for inflation)
- Annual cash outflows:
  - Production costs structure as given
  - Royalty payments of 4% of annual sales for the period
  - Profit tax at 35% rate
  - Investment in additional working capital
- Additional factors
  - Discount rate: 80%
  - Inflation forecast by years: 35%; 20%; 15%; 12% and 10%

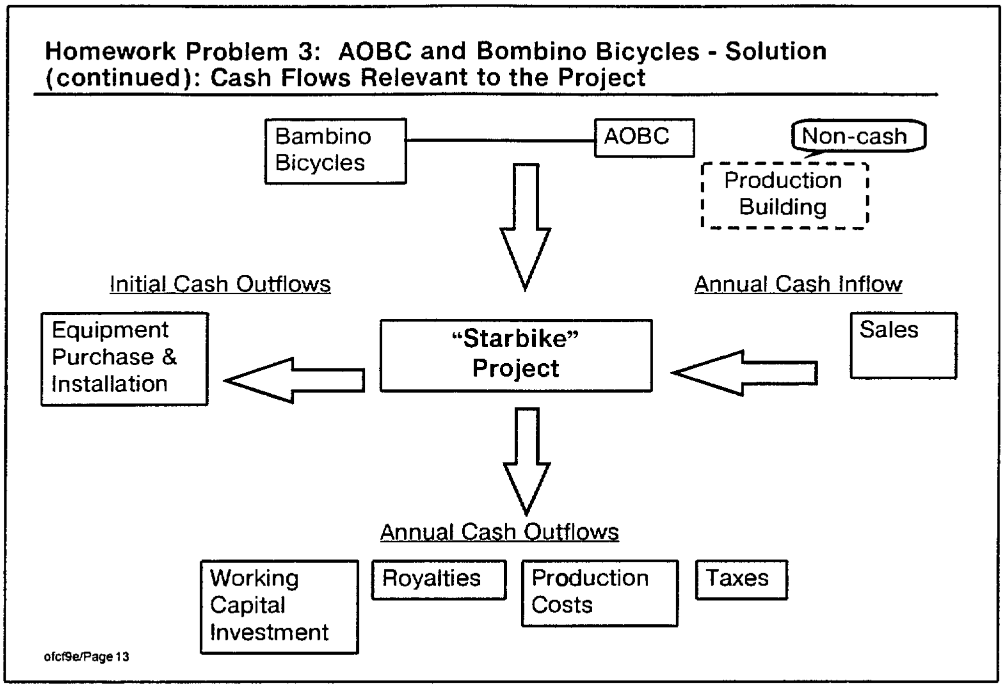
ofcf9e/Page 12

Instructor's notes:

<u>**Note**</u>:

Installation costs: one-time initial cash outflow; if they are capitalized, then the tax shield from depreciation will be RUR 420 mln instead of RUR 400 mln.

Depreciation is not cash, but it affects taxes and should be included in the projections



Instructor's notes:

258

Homework Problem 3: AOBC and Bombino Bicycles - Solution (continued)

Annual cash inflows from sales

	Year 1	Year 2	Year 3	Year 4	Year 5
Units sold	20 000	23 000	25 000	25 000	25 000
Unit price (RU '000)	540	648	745	835	919
Gross sales (RU mlns)	10 800	14 904	18 630	20 866	22 952

Unit price is calculated by inflating initial price of RUR 400,000

Annual cash outflows for production

- Total incremental costs are 65% of sales (20% + 25% + 8% + 2% +10%)
- Cash outflows for production by years are (Year Sales * 65%):
  - 7,020 m; 9,688 m; 12,110 m; 13,563 m; 14,919 m

ofcf9e/Page 14

Instructor's notes:

259

Homework Problem 3: AOBC and Bombino Bicycles - Solution (continued)

Annual cash outflows for investment in additional working capital, royalties and taxes (in RUR m)

Profit tax base net of depreciation

- installation costs are not capitalized
- annual depreciation is RUR 400 m { ($400,000 * 5,000) / 5}

	Year 1	Year 2	Year 3	Year 4	Year 5
Gross sales	10,800	14,904	18,630	20,866	22,952
Royalties	432	596	745	835	918
Pre-tax earnings	2,948	4,220	5,375	6,068	6,715
Taxes	1,032	1,477	1,881	2,124	2,350
Profit	1,916	2,743	3,494	3,944	4,365
Add back depreciation	400	400	400	400	400
Subtract WC need	**(298)**	**(308)**	**(321)**	**(359)**	**(396)**
NET CASH FLOWS	**2,018**	**2,835**	**3,573**	**3,985**	**4,369**

ofcf9e/Page 15

Instructor's notes:

260

Homework Problem 3: AOBC and Bombino Bicycles - Solution (continued)

Cash Flow Forecast
(in 000s of Rubles)

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Units Sold		20,000	23,000	25,000	25,000	25,000
Inflation	35%	20%	15%	12%	10%	10%
Sales Price	400	540	648	745	835	918
Total Sales		10,800,000	14,904,000	18,630,000	20,865,600	22,952,160
Incremental Operating Expenses		7,020,000	9,687,600	12,109,500	13,562,640	14,918,904
Incremental Depreciation		400,000	400,000	400,000	400,000	400,000
Royalty Payments		432,000	596,160	745,200	834,624	918,086
EBT		2,948,000	4,220,240	5,375,300	6,068,336	6,715,170
Taxes		1,031,800	1,477,084	1,881,355	2,123,918	2,350,309
Net Income		1,916,200	2,743,156	3,493,945	3,944,418	4,364,860
Add Back Depreciation		400,000	400,000	400,000	400,000	400,000
Subtract WC Requirement	1,863,000	298,000	308,000	321,000	359,000	396,000
Purchase of Equipment	2,000,000					
Installation Charge	100,000					
Net Cash Flow	-3,963,000	2,018,200	2,835,156	3,572,945	3,985,418	4,368,860

ofcf9e/Page 16

Instructor's notes:

261

Homework Problem 3: AOBC and Bombino Bicycles - Solution (continued)

Net Present Value Calculation

(Discount Rate: 80%)

Year	Net Cash Flow	Discount By Calculating Present Value	Present Value of Net Cash Flows (Discounted Cash Flows)
1	2,018	2,018/ 1.8	1,121
2	2,835	2,835/ $(1.8)^2$	875
3	3,573	3,573/ $(1.8)^3$	613
4	3,985	3,985/ $(1.8)^4$	380
5	4,369	4,369/ $(1.8)^5$	231
Add:	Present Values		3,220
Subtract:	Initial Investment		3,963
	Net Present Value		-743

ofcf9e/Page 17

Instructor's notes:

262

Homework Problem 3: AOBC and Bombino Bicycles - Solution (continued)

Discounting the Net Cash Flow at 80% yields an NPV of - RUR 743 m

NPV is negative → Reject → "Starbike" Project

Additional data to be prepared for the Board of Directors

- Compare discount rate with rates offered by lenders, Central bank, average rate of GKO
- Identify whether all risks are appropriately accounted for in your discount rate
- Do a sensitivity analysis, i.e. calculate NPV with higher and lower discount rates (e.g. 70% and 90%)

ofcf9e/Page 18

Instructor's notes:

263

Homework Problem 4: Your Enterprise

Required:

For your own enterprise:

1. Identify a project in which you are interested that will require long-term financing
2. Develop high-level cash flow estimates for the life of the project
3. Assume a discount rate of 40%
4. Apply the net present value formula using your cash flow estimates and the discount rate from step 3
5. Choose the most likely source of financing for your project based on the material presented today. Be prepared to explain why you chose your source of financing
6. On your return you will be asked to make a 5-minute presentation to a potential investor. Your financial advisor or another contact of yours has made an appointment. You will bring your business plan, investment memorandum, or issue prospectus to the meeting. What will you tell him in order to get him interested enough to read your business plan?

ofcf9e/Page 23

Instructor's notes:

Homework Problem 4: Your Enterprise - Discussion

Introduction:

1) Why did you select this project?
2) Did you consider other projects? If so, why were they rejected?
3) Does the project make strategic sense for your enterprise? Why?
4) What is the perceived value of the project? Will it lower costs, increase sales, improve competitiveness, provide entry into new markets?
5) Who will it benefit? Stockholders, customers, management?
6) Would you invest in this project?

ofcf9e/Page 24

Instructor's notes:

Begin by surveying the participants on the projects that they have selected. It is a good idea to write them down on a flip-chart or overhead slide as you will be discussing these projects throughout the day.

Homework Problem 4: Your Enterprise - Discussion (continued)

The following must be accounted for:

1) All cash inflows and outflows associated with the project
2) Increased working capital requirements
3) Disregard sunk costs (costs already incurred)
4) Opportunity cost, by looking at other alternatives
5) Overhead on an incremental basis (include additional costs, but not the reallocation of current costs)

ofcf9e/Page 25

Instructor's notes:

After all of the selected projects have been recorded, start examining the more interesting ones in greater detail. Have a couple of the participants explain how they estimated cash flows for the project. Set up a matrix on a flip chart or overhead to record the cash flow figures.

Discuss the importance of estimating cash flows. It is the basis for determining whether to pursue a project, so it is crucial to be honest with yourself. Mention that they have only had a short period of time to estimate cash flows and that for large projects some companies may take months to do so. Use a matrix similar to the one in the class example to display an example cash flows. What is shown may be at a higher level (consolidating some items into one line).

Homework Problem 4: Your Enterprise - Discussion (continued)

NPV Formula:

$$NPV=(CF1/(1+k) + CF2/(1+k)^2 + CF3/(1+k)^3 + CF4/(1+k)^4 + CF5/(1+k)^5) - A$$

CFn = projected net cash flow for period n of the project

A = initial investment

k = discount rate

ofcf9e/Page 26

Instructor's notes:

The next step is to discuss the NPV calculations.

Review the meaning of the discount rate. Use the tool for calculating the discount rate as background in your discussion. Stress that discount rates for ruble and dollar cash flow projections will be different because of different risks involved.

Ask the participants how many of them were able to get to the stage of calculating NPV. What prevented those who did not get that far from doing so? (time, did not understand discount rate calculation, had difficulty determining cash flows). If the problem is a lack of understanding, spend a little more time on the subjects in question before going on.

Review the NPV formula, explaining the meaning of the variables.

Select a couple of participants to demonstrate how they calculated their NPV. They should begin by writing down their projected cash flows for each year of the project and establishing their discount rate. Do the cash flows and discount rate look realistic? If not, ask what they are based on.

Have one of the participants demonstrate his NPV calculations.

Homework Problem 4: Your Enterprise - Discussion (continued)

What type of financing have you chosen to pursue?

How appropriate is this source for your project?

ofcf9e/Page 27

Instructor's notes:

Return to the list of projects made at the beginning of the discussion. For each project ask the respective participant what kind of financing he has chosen to pursue. This discussion should highlight the distinctions between equity and debt financing. You should also inquire as to whether the participant has considered sources of internal financing. Write down the types of financing chosen on the flip chart or slide next to the appropriate project. It is also important to ask how much the participant hopes to raise through this financing.

Discuss the appropriateness in each case. Seek other alternatives from the participants.

Propose the following scenario to the class: They have selected a project based on the NPV method. Each has prepared the necessary supporting documentation (ask for responses on what that information should include). A potential investor has expressed some interest in the project and has invited the enterprise for a presentation. Each participant should now get up and give a 5-minute presentation to the class explaining the benefits of his project and why the investor would be wise to help finance it.

After each presentation, poll the class on their response. Are they interested? What else do they want to know? What makes them hesitant to join in the project? After all have presented, poll the class for the project that they like the best and would invest in if they were an investment company. What do they like?

Homework Problem 4: Your Enterprise - Discussion (continued)

In Summary:

1) Companies should be looking toward continuous development
2) Financing is required for such development
3) Financing can come from inside the company or from outside sources and can be for a short or long term
4) Financing has a cost
5) NPV is the best method for determining whether a project should be selected. Explain that NPV seeks to find the present value of the expected cash flows of an investment, discounted at the cost of capital. A positive NPV indicates that the project will provide a return greater than the cost of capital, and therefore should be seriously considered as credible
6) External long-term finance can come from debt financing or equity financing
7) Investors require substantial information (a business plan, an investment memorandum, an issue prospectus) in a structured format so that they can evaluate the benefits of the project

ofcf9e/Page 28

Instructor's notes:

TOOLKIT

Essentials of Corporate Finance and Obtaining Finance

Seminar for Management

August-September 1996

Handouts

270

Handouts

- Glossary of Terms
- Calculating the Net Present Value (NPV) of an Investment Project
- Calculating the Discount Factor and the Cost of Capital (WACC)
- Sources of Financing: Contact Information
- Aid Funded Sources of Financing: Criteria and Procedures
- Business Plan for the EBRD
- Investment Proposal to the IFC
- Selected References

ofcf/Page 2

Glossary of Terms

PIES TOOLKIT
OBTAINING FINANCE MODULE
GLOSSARY OF TERMS

"Aid" Fund An investment fund created with the participation of one or more foreign governments with a political mandate to stimulate investment in the region, usually in investments that might not otherwise receive financing.

American Depository Receipt (ADR) A security issued in the US to represent shares of a foreign stock, enabling that stock to be traded in the US.

Asset Valuation An estimation of the true market value of an enterprise's tangible assets.

Asset Valuation: Cost Approach Asset valuation based on the cost of purchasing a similar asset.

Asset Valuation: Direct Sale Comparison Approach Asset valuation based on free market prices for assets of equal utility and quality

Asset Valuation: Income Approach Asset valuation based on the present value of future income and benefits of assets.

Bond A long term debt of a firm. In common usage, the term bond often refers to both secured and unsecured debt.

Book Value Value of assets in financial accounts of the enterprise

Business Valuation An estimation of the true market value of the business operations of a going concern.

Capital Markets Valuation Business valuation which reflects value of shares by comparison with prices of shares traded in a stock market

Cash Payback Calculation of the number of years required to recover the initial investment in a project. Cash payback is a method of evaluating capital expenditure proposals.

Charter Capital The original value of its share capital from privatization, plus any adjustments made based on asset revaluation.

Commercial Paper Short term, unsecured promissory notes issued by companies.

Company Valuation An estimation of a reasonable range of market values for the company's share capital, used by management to negotiate percentage ownership to offer for a given amount of investment; May be done by company or its financial advisors

Convertible Bond A bond that may be converted into another form of securitiy, typically common stock, at the option of the holder at a specified price for a specified period of time.

Corporate Finance The activities of deciding in which long term assets a company should invest, raising cash for capital expenditure, and managing short term operating cash flows.

Cost of Capital The weighted average of the required return on a company's stock and debt in capital markets. It is a cost from the firm's perspective.

Discounted Cash Flow (DCF) An estimation of the benefits available to the investor after paying all expenses related to operating the business. Future cash flows are discounted back to their present value equivalent using a discount rate that matches the investor's required rate of return.

Factoring Sale of a company's accounts receivable to a financial institution known as a factor.

Fair Market Value (FMA) A reasonable estimate of the price at which property would change hands between two willing parties.

Federal Commission for Securities and Stock Markets The governing body of the Russian capital markets.

Financial Due Diligence A review of the financial situation of an enterprise to determine the financial risks of investing in or being associated with the enterprise from the point of view of an investor, including the identification of future potential financial liabilities of the company.

Generally Accepted Accounting Principles (GAAP) A common set of accounting concepts, standards, and procedures by which financial statements are prepared in the US.

Global Depository Receipt (GDR) A security issued in more than one country to represent shares of a foreign stock, enabling that stock to be traded in those countries.

Goodwill The ability of a business to earn above normal earnings with the identifiable assets employed in the business, based on the company's name, business reputation, and contacts. An intangible asset recorded only in a merger, reorganization, or change of partners in a partnership.

Internal Rate of Return (IRR) A disoucnt rate at which the net present value of an investment is zero. The IRR is a method of evaluating capital expenditure proposals.

International Accounting Standards (IAS) A common set of accounting concepts, standards, and procedures by which financial statements are prepared in countries in Europe and in other countries.

Lease A contractual arrangement to grant the use of specific fixed assets for a specified time in exchange for payment, usually in the form of rent. An operating lease is generally a short-term cancelable arrangement, whereas a capital lease is a long-term noncancelable agreement.

Legal Due Diligence A review of a firm's privatization, current structure, contracts with suppliers and customers, etc. from a legal standpoint, to identify any possible future legal claims against the company.

Liquidation Value Value of an enterprise assuming the company's operations are expected to be discontinued and that its assets will be sold on a "piecemeal" basis.

Market Value of Equity The current market value of all shares is the price at which the shares would change hands if sold in an open market between a willing buyer and seller, and reflects the market's view on the future earnings potential. The process of valuation attempts to determine this figure.

Mutual Settlement/Offset Cash obligations between companies which are settled by delivery of goods between two or more parties

Net Present Value (NPV) The present value of future cash returns, discounted at the appropriate market interest rate, minus the present value of the cost of the investment. NPV is a method of evaluating capital expenditure proposals.

Nominal Capital Charter capital.

Overdraft Facility Ability for the company to withdraw more funds than its has on deposit at the bank

Portfolio Investor An investor seeking predominately a financial return from an investment. Includes investment funds, pension funds, insurance companies, etc.

Pre-emptory Rights Rights of existing shareholders to purchase the shares in a new issue in proportion to current holdings.

Private Placement The sale of a security directly to a limited number of investors.

Professional Association of Securities Markets Participants (PAUFOR) A self regulatory organization uniting securities markets participants setting standards and influencing regulatory reform in the capital markets in Russia. Also runs an interregional electronic securities trading system similar to the NASDAQ system in the US.

Prospectus The legal document that must be given to every investor who contemplates purchasing registered securities in an offering. It describes the details of the company and the particular offering. The Russian statutory requirements for a prospectus do not currently provide information sufficient for a potential investor to make an investment decision; therefore some Russian companies have also created a "selling memorandum", which is similar to a western prospectus, to provide this information.

Receiving Banks Banks accepting applications and payments from investors in new issues of securities.

Rights Issue An issue of rights to purchase new shares. Applicable in countries where preemptive rights exist (as in Russia as per the Joint Stock Company Law of January 1, 1996).

Securities and Exchange Commission (SEC) The governing body of the US capital markets.

Selling Memorandum A document similar to a western prospectus which includes information (not included in a Russian statutory prospectus) needed to sell shares in a public issue.

Share Capital Charter capital plus any equity generated by past retained earnings, sale of shares over nominal value, etc.

Share Trading Price In developed capital markets, the current trading price per share multiplied by the number of shares should give the market value of equity. In Russia, however, the shares of few companies are actively, and openly traded, making this a poor indication of true value.

Strategic Investor An investor seeking benefits other than purely financial return from an investment, and offering benefits other than purely finaincing. Usually a company in a similar, related, or the same industry.

Terminal Value Present value of cash flows in perpetuity after a project has reached a stabilized level of operations (stable growth and sustainable profit margins). Part of the net present value of a project.

Tolling A means by which a processor is provided with raw materials at no cost, processes them and returns the finished product to the owner. The processor is compensated by the owner for this work.

Trade Credit Credit received from suppliers in the normal course of business

Trade Transactions Valuation Business valuation which is based on the price paid for similar companies when sold to another company or investor

Underwriter An investment firm which buys an issue of securities from the issuer and resells it to investors.

Venture Capital Investment funds earmarked for high risk investments, requiring corresponding high returns. Usually funds for start-up businesses.

Calculating Net Present Value (NPV) of an Investment Project

Tool for Calculating Net Present Value (NPV) of an Investment Project

- Calculate capital investment required to implement the project
- Forecast net project cash flows
- Assess risks associated with the project
- Estimate the appropriate discount rate
- Calculate NPV, using discounted cash flows

Reject projects with negative NPVs. Accept projects with positive NPVs.
If projects are mutually exclusive, select the project with the highest NPV.

ofcf/Page 5

380

Calculate Initial Capital Investment Required for Project Start-up and Investment Requirements for Each Year of the Project

Enter cash inflows as positive and cash outflows as negative.

Capital investment	Initial	Year 1	Year 2	Year 3	Year 4	Year 5	Total	Depreciable Basis
Land								
Buildings								
Equipment								
Installation costs								
Other								
Total Investment								

ofcf/Page 6

381

Include Only Relevant Cash Flows into the NPV Calculation

- Only incremental cash flows should be included: enterprise CF with project less CF without project
- Account for all cash inflows and outflows directly associated with the project
- Only quantifiable and traceable to the project costs should be included
- Sunk costs (costs already incurred) should not be included
- Fixed costs not directly associated with the project should not be included
- After tax cash flows are relevant (deduct tax payments)
- Depreciation is not a cash outflow, but the reduction of taxes based on depreciation expense needs to be accounted for
- Investments into working capital over the life of the project should be properly accounted for

Take Inflation into Account When Forecasting Project Cash Flows

Inflation will have impact on costs of inputs as well as your sales prices

- forecast impact of inflation on costs of raw materials, energy, labor, etc.
- price increases for different inputs may vary
- make a realistic forecast of your ability to raise prices of your products while staying competitive
- if you incur most of your costs in rubles, but most of sales are export sales for dollars (or other currency), you will be exposed to foreign exchange risks

Take inflation into account and forecast nominal cash flows for each year of project life.

You have to treat inflation consistently: if your discount rate is a nominal rate, then cash flows should be estimated in nominal terms as well.

Instructions to Cash Flow Forecasting Worksheet

A. Forecast project startup costs and the time at which the costs will be incurred

B. Forecast sales
   - consider at least three possibilities (best, worst, expected)

C. Forecast production costs (those not included in startup costs)
   - all labor, energy, materials, or other costs applicable to production

D. Forecast operating overhead costs and sales costs
   - administration costs, all non-profit taxes, selling costs, transportation costs, and any other cost not related to production

E. Estimate depreciation on the new assets

F. Calculate profit tax considering any likely tax breaks (including interest expense deductions)

G. Estimate the additional investment required to build up working capital

H. Consider what new investments can be funded from project cash flows

ofcf/Page 9

Forecast Net Project Cash Flows

Enter cash inflows as positive and cash outflows as negative.

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Sales volume (in units)						
Inflation for the period						
Sales price						
Sales revenue						
Royalty payments						
Raw materials						
Electricity						
Gas and water						
Spare parts						
Depreciation-Building						
Depreciation-Equipment						
Wages						
Overhead expenses						
Earnings before taxes						
Taxes						
Earnings after taxes						
Add back depreciation						
Project cash flows						
Working capital needs						
Capital investment						
Salvage value						
Net Cash Flows						

ofcf/Page 10

285

Alternate Tool for Forecasting Project Cash Flows (Example)

Year	Land	Building	Machinery	Installation	Change in Working Capital	Other	Total Investment	Qty Sales	Period Inflation	Sales Price	Sales Revenue	Raw Materials	
0	- 500	- 500	- 2,000	- 200	- 220	- 80	- 3,500	0	35%	$ 113.00	-	-	
1							-	100	22%	$ 137.86	13,786	- 2,757	
2							-	150	18%	$ 162.67	24,401	- 4,880	
3							-	175	15%	$ 187.08	32,738	- 6,548	
4							-	200	10%	$ 205.78	41,157	- 8,231	
5							-	225	8%	$ 222.25	50,005	- 10,001	
6							-	250	7%	$ 237.80	59,451	- 11,890	
7							-	250	7%	$ 254.45	63,612	- 12,722	
8							-	250	7%	$ 272.26	68,065	- 13,613	

Electricity	Gas and Water	Spare Parts	Add'l Workers Salaries	Depreciation on Buildings	Depreciation on Machinery and Equipment	Earnings Before Taxes	Taxes at 35%	Earnings After Tax	Addback: Depreciation	Project Cash Flows
-	-	-								- 3,500
- 689	- 483	- 2,068	- 450	- 25	- 200	7,114	- 2,398	4,366	225	4,591
- 1,464	- 976	- 3,660	- 531	- 25	- 200	12,665	- 4,341	7,974	225	8,199
- 2,292	- 1,637	- 4,911	- 611	- 25	- 200	16,516	- 5,689	10,477	225	10,702
- 3,293	- 2,675	- 6,174	- 672	- 25	- 200	19,887	- 6,869	12,669	225	12,894
- 4,500	- 3,500	- 7,501	- 725	- 25	- 200	23,552	- 8,151	15,051	225	15,276
- 5,945	- 5,351	- 8,918	- 776	- 25	- 200	26,346	- 9,129	16,867	225	17,092
- 6,361	- 5,089	- 9,542	- 831	- 25	- 200	28,842	- 10,003	18,489	225	18,714
- 6,807	- 6,466	- 10,210	- 889	- 25	- 200	29,856	- 10,358	19,148	225	19,373

ofcf/Page 11

Instructions for NPV Calculation Worksheet

Write net cash flows for each year of project life in column A.

Calculate the discount factor for each year and write in column B.

–Discount factor for year n = $1/(1+\text{discount rate})^n$

You may take the discount factor from the Discount Factor table.

Multiply net cash flows (column A) by discount factor (column B) and write results in column C.

Sum the discounted cash flows in column C. This is the present value of cash flows from the project.

Subtract the initial investment. You have calculated the Net Present Value of the project.

Calculate Net Present Value of the Project

$$NPV = (CF_1/(1+k) + CF_2/(1+k)^2 + CF_3/(1+k)^3 + ... + CF_n/(1+k)^n) - I_0$$

I_0 -- initial investment, CF_n -- net cash flow in year n, k -- discount rate, $1/(1+k)^n$ -- discount factor

Year	Net cash flow *A*	Discount factor *B*	Discounted cash flow *C*
Year 1			
Year 2			
Year 3			
Year 4			
Year 5			
Year n	CF_n	$1/(1+k)^n$	$CF_n/(1+k)^n$
Add up: Present Value			
Subtract: Initial Investment			
Net Present Value			

ofcl/Page 13

288

Discount Factor table

Discount Factor = $1/(1+k)^n$

Period (n)	10%	15%	20%	25%	30%	35%	40%	45%	50%
	Discount Rate (k)								
0	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
1	0.909	0.870	0.833	0.800	0.769	0.741	0.714	0.690	0.667
2	0.826	0.756	0.694	0.640	0.592	0.549	0.510	0.476	0.444
3	0.751	0.658	0.579	0.512	0.455	0.406	0.364	0.328	0.296
4	0.683	0.572	0.482	0.410	0.350	0.301	0.260	0.226	0.198
5	0.621	0.497	0.402	0.328	0.269	0.223	0.186	0.156	0.132
6	0.564	0.432	0.335	0.262	0.207	0.165	0.133	0.108	0.088
7	0.513	0.376	0.279	0.210	0.159	0.122	0.095	0.074	0.059
8	0.467	0.327	0.233	0.168	0.123	0.091	0.068	0.051	0.039
9	0.424	0.284	0.194	0.134	0.094	0.067	0.048	0.035	0.026
10	0.386	0.247	0.162	0.107	0.073	0.050	0.035	0.024	0.017

Period (n)	55%	60%	65%	70%	75%	80%	85%	90%	95%	100%
	Discount Rate (k)									
0	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
1	0.645	0.625	0.606	0.588	0.571	0.556	0.541	0.526	0.513	0.500
2	0.416	0.391	0.367	0.346	0.327	0.309	0.292	0.277	0.263	0.250
3	0.269	0.244	0.223	0.204	0.187	0.171	0.158	0.146	0.135	0.125
4	0.173	0.153	0.135	0.120	0.107	0.095	0.085	0.077	0.069	0.063
5	0.112	0.095	0.082	0.070	0.061	0.053	0.046	0.040	0.035	0.031
6	0.072	0.060	0.050	0.041	0.035	0.029	0.025	0.021	0.018	0.016
7	0.047	0.037	0.030	0.024	0.020	0.016	0.013	0.011	0.009	0.008
8	0.030	0.023	0.018	0.014	0.011	0.009	0.007	0.006	0.005	0.004
9	0.019	0.015	0.011	0.008	0.006	0.005	0.004	0.003	0.002	0.002
10	0.012	0.009	0.007	0.005	0.004	0.003	0.002	0.002	0.001	0.001

ofcf/Page 14

Calculating a Discount Factor and Cost of Capital (WACC)

ofcf/Page 15

340

Considerations in Selecting a Discount Factor

In order to select the best projects, it is essential to apply an appropriate discount factor to your calculated cash flows. But what is the right discount factor?

- The appropriate discount factor depends on the financing or *capital* used for the project
  - If *internally* financed the rate is dependent on the cost of the company's debt and equity, which is the cost of the company's capital:
    - portion of short-term debt that will be extended into the long-term
    - long-term debt
    - preferred stock
    - common equity
  - If *externally* financed the rate depends also on the new debt and new equity costs.

The cost of debt or equity is the payments the company makes for that type of financing.

- For debt this is the interest payments and transaction costs
- For equity this is the dividend payments and selling costs of new share issues in addition to the growth in price of the currently outstanding shares that shareholders expect in order to keep the shares.
  - If the enterprise is not currently making dividend payments, this does not mean there is no cost of its equity

ofcf/Page 16

Calculating Discount Factors is Very Subjective

Some inputs to the formulas for calculating discount factors are market based; some are judgmental. The latter depend on your view of your project and the Russian economy as a whole.

Calculating discount factors is therefore an uncertain exercise; but if business were always a certain endeavor, we would all be billionaires

So why is it useful to calculate a discount factor and discount cash flows?

- For better understanding of the project and its benefits:
  - forces the project manager to quantify all relevant factors relating to undertaking the project
- For comparison purposes:
  - selecting among projects - if your methodology is consistent, you will make the right decision in selecting among projects for financing
  - evaluating projects over time - again, if your methodology is consistent, you will be able to judge over time how your view of the project or the economy has changed, and therefore how value of the project has changed
- For presenting to potential lenders/investors:
  - lenders/investors may disagree with the discount factor you came up with, but you will have a negotiating position to start with, and they will be impressed that you have considered all relevant factors in selecting your project

294

A Discount Rate Might Be Based on the Company's Cost of Capital

- What specifically constitutes a discount rate for a potential project?
- The appropriate discount rate for any project is the rate of return which should be expected if you invested in a different project with similar risk.
- In theory, the discount rate should take into account the structure of the financing used for the project, weighted appropriately. The cost of capital for a project cannot be only the cost of debt financing, however, because the enterprise will not be able to continue to finance all development with debt; the cost of debt will rise with increased leverage of the company, and will eventually become unavailable; the company will eventually be forced to resort to equity financing.
- The discount factor should not be higher for later projects, which will have to be financed by equity financing, than for earlier projects, financed by debt, if they have the same risk.
- Therefore the cost of capital should always be equal to a weighted average of existing debt and equity in the company and the new financing (be it debt or equity):

Weighted Average Cost of Capital (WACC) =(cost of debt)*(% of debt) + (cost of equity)*(% of equity)

- Example: A project requiring RU 2 b is financed with RU 1.5 b of debt at 120% yearly interest and RU 0.5 b of equity which currently provides investors a return of 140% yearly:

  Weighted Average Cost of Capital (WACC)=(1.2)(1.5/2) + (1.4)*(0.5/2) = 1.25 or 125%*

ofcf/Page 18

Answer: There is no one right answer. If both projects are financed identically, the appropriate rate is probably the rate calculated using the proposed discount rate equation and not the WACC. Why? Because of the difficulties in calculating return on equity in Russia.

This example highlights the subjectivity in calculating discount factors - because if there were no ambiguities, both calculations would provide the same result.

An Alternative is to "Build" a Discount Rate Based on a "Risk Free" Rate and a Risk Premium

In practice, especially in Russia, WACC is difficult to calculate, especially because of the difficulty in finding the cost of equity, therefore a reformation is proposed:

Proposed discount rate = Risk-free rate + Risk premium

The risk-free rate (or reduced-risk rate) in Russia represents the rate of return an investor can expect from putting money into the most reliable financial instruments available for the same time horizon (in Russia).

A hypothetical example (estimating these rates is explained below): The risk free rate is 130% and the risk premium on a project is 8%.

Proposed discount rate = 130 + 8 = 138%

Question: If the projects in both examples above have the same risks, which is the appropriate discount rate?

Answer: Theoretically, they should give the same answer. In practice, there will usually be a difference. It is up to management to reconcile these figures, based on the assumptions used in calculating each.

The rest of this document discusses how to approach the problem of choosing a risk free rate and a risk premium for a project.

What is a Risk-Free Rate and How Do You Choose One?

In a stable economic environment government securities are regarded as the most risk reduced (or risk-free) investments as these instruments are backed by the national government.

- Examples of real risk-free rates:
  - Rates on treasury bills
  - Rates on government bonds

Which rate best reflect the real risk-free rate in Russia?

- Since capital markets are still developing in Russia, it's recommended to take into account several financial instruments to determine an appropriate real risk free rate, for example: e:
  - Average rates of GKO and OGSZ
  - Rates offered by lenders
  - Returns from holding hard currency (currently artificially low due to ruble corridor)
  - Central bank discount rate
- The risk-free rate you choose takes account of expected future inflation and the minimum returns available by selecting the safest financial instruments available.
- The main problems with using any of the securities listed above as the basis for a risk free rate are
  - they are not themselves freely traded in the market
  - the terms of these securities do not correspond to the time horizon of most investment projects.

295

Interest Rates on Securities Have Two Components

Let's consider the following financial markets information:

- 6 month GKOs are at 190% annual interest rate
- Central bank lending rate is at 140%
- Bank interest rate (annual) on hard currency deposits - 16%
- Average lending rate of the top 25 Russian banks - 180%
- Ruble inflation is currently at 2.8% per month

These rates have two components:

1) The <u>real</u> risk free rate (without inflation)
2) Inflation component

Let's consider two of the instruments listed above

GKO rate for 6 months:	85%
Ruble inflation rate for 6 months:	<u>18%</u>
Real risk free rate:	67%

Bank rate (annual) on hard currency deposits:	16%
Yearly dollar inflation:	<u>3%</u>
Real risk free rate:	13%

ofcf/Page 21

3416

Calculating a Real Risk Free Rate

Real risk free rate from 6 month GKOs:	*67%*
Real risk free rate from rate on hard currency deposits:	*13%*

Why are they so different?

- The GKO market is heavily regulated and excludes major players (foreign investors) from participating in any substantial numbers. Therefore, this is not a true market rate.
- The ruble corridor keeps the rate on hard currency deposits in Russia artificially low. This is also not a true market rate.

So what is the true real risk free rate?

Based on averages of rates determined by the method above and other analysis, the current real risk free rate in Russia is believed to be between 20% and 25%.

Inflation would need to be added back to the real risk free rate to get the nominal risk free rate to discount nominal cash flows.

ofcf/Page 22

Adjusting the Risk Free Rate for the Time Horizon of the Project

Let's imagine you have a project from which cash flows are projected for ten years. How will you choose a nominal risk free rate?

Real risk free rate + inflation component = 23% + 80% = 103%

But how long do you expect inflation to continue at this rate? For the entire time horizon of the project (10 years)? If not, adjustments need to be made to arrive at appropriate risk free rates over time. These adjustments are subjective and depend on your view of the timing of economic recovery in Russia. If you expect a partial recovery of the Russian economy, you might forecast yearly inflation to drop to 55% after two years, then to 35% after two more years, then to 15% for the remainder of your time horizon.

Therefore your risk free rate would be equal to:

1996-1997:	23% + 80% = 103%
1998-1999:	23% + 55% = 78%
2000-2001:	23% + 35% = 58%
2002-2005:	23% + 15% = 38%

If you are able to obtain subsidized financing, at rates significantly less than commercially available rates, then this rate can serve as the risk-free rate for further calculations, but should first be adjusted upward to take into account market requirements to arrive at a risk-free rate, if the subsidized rate won:t be available throughout the life of the project.

ofcf/Page 23

298

What is a Risk Premium and How do You Choose One?

The final step is to choose a risk premium for the project. The risk premium is the extra return required on the project which investors demand to pay for undergoing risks not already considered in the risk-free rate and not reflected in the project's cash flows, such as:

- Additional project risks (estimated between 0% and +20%):
  - Risks not reflected in the business plan or cash flows but specific to the project
- Business risks (estimated between -10% and +10%)
  - Financial leverage of the company, i.e. debt/equity ratio (as leverage increases, risk associated with the company increases - the interest it must pay before distributable profits becomes greater)
  - new legislation specifically affecting the company's operations
  - new competitors entering the market
- Foreign exchange risks (estimated between -10% and +10%)
  - for projects with settlement in hard currency only

A negative value means risk is being removed due an expected positive effect.

ofcf/Page 24

Choosing on a Risk Premium

Your project is to build a baby-food factory using only locally grown, and ecologically clean products. Your main business is processing of rare earth metals. Also, the new local governor s wife is pregnant with twins.

- Additional project risks (here choose +12%):
  - You are aware of some internal management conflicts which may affect the project
- Business risks (here choose +10%)
  - New environmental legislation might negatively affect your production process
- Foreign exchange risks (here no effect)
  - all your cash inflows and outflows will be in rubles

In this project the resultant risk premium would be 22%.

Question: If your rate is less than zero this means your project is less risky than currently available financial instruments considered the most risk-free. Is that a good assumption?

Answer: No, its not a good assumption. By making this assumption you are assuming the government is more likely to default on its debt than the risk of your project s defaulting. You may argue the government is on the brink of default already while your project is rock solid, but to the investor who assesses the project, and who invests, the cash flows from your project will not be available, due to instabilities introduced by government default. Therefore, the minimum risk premium should always be higher 0% or higher.

ofcf/Page 25

Your View on the Economy also Influences the Risk Premium

Based on conversations with foreign portfolio investors, current risk premiums in Russia tend to be between 20% and 30%. In developed markets, risk premiums tend to be 6% to 8%.

The risk premium can also vary over time as business and project risks in Russia decline with a stabilization of the economy. This again, depends on your view. Let's assume you believe in rapid stabilization of the factors affecting the risks of your business and your project. You might decide on the following risk premiums:

1996-1997:	22%
1998-1999:	18%
2000-2001:	15%
2002-2005:	12%

Calculating Discount Factors

Choosing a risk free rate

- Select a real risk free rate: 23%
- Ad inflation component:
  1996-1997: 23% + 80 = 103%
  1998-1999: 23% + 55% = 78%
  2000-2001: 23% + 35% = 58%
  2002-2005: 23% + 15% = 38%

Choosing a risk premium

- Calculate risk premium:
  - Project risks + 12%
  - Business risks + 10%
  - Foreign exchange risks + 0%
  - Total risk premium: + 22%
- Adjust over time:
  1996-1997: 22%
  1998-1999: 18%
  2000-2001: 15%
  2002-2005: 12%

Calculating the discount factors:

1996-1997:	**103% + 22% = 125%**
1998-1999:	**78% + 18% = 96%**
2000-2001:	**58% + 15% = 73%**
2002-2005:	**38% + 12% = 50%**

ofcf/Page 27

A Question Commonly Asked About the Discount Rate

I've got a subsidized loan at 40% to finance my whole project, and at this rate the NPV of my project is positive, but at the rate I calculated using this tool, my NPV is negative. Why shouldn't I just use the rate of my subsidized loan.

- The rate calculated using this tool attempts to find a rate which will enable you to select projects allowing follow-on investments in the future. If your project provides a return only slightly higher than 40% over the life of the project, while the market is providing a return of 120%, then when it is time to refinance you will have to find another subsidized loan because your past return has under-performed the market. Choosing your projects based on the discount factor calculated using this tool shows the minimum levels of return the market will require enabling senior management to stimulate project initiators to find ways to reduce costs or increase revenues until the project's cash flows meets the demands of the market. In this way, your company will be stimulated to become efficient, technologically advanced and responsive to the market and will, therefore, flourish in the market and not be dependent on subsidized loans.
- If you can't find a project that provides a positive NPV using the discount rate calculated using the tool, you either have selected a project the market will not support or are not carrying-out the project in the most efficient manner, so you will have to find a subsidized rate to support your project now, and in the future.
- If the subsidized rate is for the entire period of the project, the subsidized rate should still not be used as the discount rate, but should be incorporated into the WACC, as explained earlier.

ofcf/Page 28

Sources of Financing: Contact Information

ofcf/Page 29

Aid-Funded Sources of Finance

Criteria & Procedures

ofcf/Page 30

International Organizations Offer Several Types of Support

Type of Assistance	EBRD	IFC	Investment Funds	OPIC	MIGA	TDA
Direct Loans						
Equity Investments						
Loan Guarantees						
Political Risk Insurance						
Grants						

ofcf/Page 31

This is an overview slide that introduces the basic services available from different international lending agencies

It is meant as an introductory slide that sets up the flow of the rest of the section

306

Multilateral Institutions such as the EBRD and the IFC Provide Project Financing Through Loans, Loan Guarantees and Direct Investment

The European Bank for Reconstruction & Development (EBRD) is a multilateral financial institution lending and investing exclusively in the countries of Central and Eastern Europe. The EBRD and IFC have many similarities in their services and strategies:

- The bank provides **loans, equity investments** and **debt guarantees** to:
  - help develop the private sector
  - increase foreign direct investment
  - create and strengthen financial institutions
  - build a modern infrastructure
  - promote small and medium-sized enterprises
  - improve the environment
- The EBRD was established in 1991, with capitalization of over $12 million
- The U.S.A., Japan, and the countries of the EU are the largest shareholders
- At least 60% of its lending must go toward private sector development projects
- To date, the EBRD has spent over $2.8 billion in the NIS
- Target sectors: telecommunications, energy, transportation, infrastructure, and banking

ofcf/Page 32

- The EBRD and IFC are discussed jointly, because of the similarities in their services and strategies
- This slide provides background on EBRD only. The IFC background follows

International Finance Corporation

Background

- The IFC is a member of the World Bank Group, established in 1956 to encourage private sector development in developing countries
- The IFC's authorized capital is $2.45 billion
- The IFC has a mandate to:
  - Provide loans and equity to viable private sector projects
  - Mobilize capital from other sources
  - Provide advisory services

The IFC provides a full array of financial products and services either alone or in combinations:

- Long-term loans
- Equity investments
- Quasi-equity instruments (subordinated loans, convertible debentures preferred stock, income participating notes)
- Guarantees and standby financing
- Risk management (intermediation of currency and interest rate swaps, provision of hedging facilities)

ofcf/Page 33

- This is simply a background slide on the IFC

The EBRD and IFC Take a Similar Approach Toward Project Financing

Their primary targets for financing are:

- Private companies, or state-owned enterprises undergoing privatization
- New companies, including joint ventures with strategic investors
- Projects which have a "multiplier effect" such as demonstrating additional benefits to the local economy, mobilizing co-financing or relieving infrastructure bottlenecks

Both seek to provide the form of financing that best matches a project, but certain guidelines apply

- Project Size
  - The EBRD will fund up to 35% of the total cost of a greenfield project, or 35% of the long-term capitalization of an established company
  - Typical EBRD projects are based on no more than 2/3 debt financing and at least 1/3 equity financing
  - The IFC will usually provide loans for up to 25% of total cost for greenfield projects or 40% of total project case in case of expansions
  - The IFC will only make equity investments of 10-15% of total project cost
  - The EBRD generally spends no less than **$7 million** for any single project, while the IFC prefers at least **$10 million. The range for IFC projects is $1 million to $100 million**

ofcf/Page 34

The EBRD and IFC Take a Similar Approach Toward Project Financing (2)

Both seek to provide the form of financing that best matches a project, but certain guidelines apply (cont.)

- Significant equity contributions from other investors are required. In greenfield projects or new joint ventures, industrial sponsors with special technical skills are expected to have a majority interest or adequate operating control
- Equity from sponsors may be in the form of cash, equipment, or machinery
- Neither the EBRD or the IFC will finance the purchase of existing or new shares

Lending rates and terms are based on commercial norms

- Both institutions operate on a commercial basis, and price their loans at market rates reflecting country and commercial risks
- **Currencies**
  - Both will loan in major hard currencies, as best suits the project
  - The EBRD will also loan in local currency
- **Security**
  - Loans are usually secured with project assets, such as: a mortgage on fixed or movable assets; the assignment of the company's hard currency and domestic currency earnings; a pledge of the sponsor's shares in the company

The EBRD and IFC Take a Similar Approach Toward Project Financing (3)

Lending rates and terms are based on commercial norms (cont.)

- Interest Rates
  - Rates may be fixed or variable
  - Rates are set at a margin over a market benchmark - usually LIBOR + a spread that reflects current country and project risk
  - Each institute offers hedging instruments to manage commodity, foreign exchange, and interest rate risks
- Repayment
  - Loan maturities range from 5-10 years for the EBRD and 7-10 years for the IFC, depending on the project's operational requirements
  - Repayment of principal will normally be in equal, semi-annual installments
  - Loans must be paid back in the currency in which they are originally lent
- Fees
  - Front-end fees will be charged at signing to cover administrative expenses
  - Commitment fees on un-disbursed (but approved) loans are also charged
  - Syndication fees will be charged in cases of financing through third-party banks and funds
  - An annual supervision fee may be charged

ofcf/Page 36

The IFC's instruments to assist with risk management are:

- **Instruments**
  - Swaps, options, forward contracts
- **Services**
  - commodity price hedging, currency risk hedging and interest rate risk hedging
- **Guarantees**

The EBRD and IFC Take a Similar Approach Toward Project Financing (4)

Lending rates and terms are based on commercial norms (cont.)

- Expenses
  - Sponsors will be responsible for reimbursement of both institutions' out-of-pocket expenses, as well as fees for technical consultants and outside legal counsel
- Insurance
  - Funded companies must obtain adequate insurance against normally insurable risks, but *not* against political risk or non-convertibility of currency
- Recourse
  - Recourse to a sponsor is not required, but both institutions may seek specific performance and completion guarantees from the sponsors

Finally, both institutions avoid government-guaranteed projects

3/2

Both the EBRD and the IFC Have High Standards for Selection

Hard currency generation

- IFC projects must generate hard currency, or have reliable access to conversion mechanisms
- For an EBRD loan to be made in hard currency, the project must demonstrate the ability to generate hard currency or the ability to absorb increases in local currency financing costs should there be any devaluation during the loan period

Enterprise/project management

- Neither institution takes an active management role in their projects. Therefore, quality of project management is a key evaluation factor
- The IFC looks for projects which include a strong Western partner with the management, market and/or technical expertise to assume managerial control over the project

Commercial viability

- Strong, committed sponsors: technically and financially
- Financially, commercially and environmentally sound and feasible

Strategic Goals

- Multiplier effect (i.e. additional benefits beyond simply firm-level assistance)
- Fit with country development strategy

ofcf/Page 38

- The purpose of this slide is to highlight the main areas of focus that the EBRD and IFC use when evaluating a project. It should be stressed that the cash flow and other financial requirements must be CREDIBLE, and that this is where problems often arise
- "Multiplier effect" refers to the idea of projects which have additional benefits beyond simply firm-level assistance. For example, if restructuring a large distribution and wholesaling enterprise results not only in a healthier company, but also increased access to consumer goods for the population, that is a multiplier effect

Equity Investments

Equity investments are undertaken by the EBRD and the IFC in a variety of forms

- Subscriptions to ordinary or preferred shares
- Subordinated loans
- Debentures and income notes
- Redeemable preference shares
- Underwriting of share issues by agreeing to subscribe to shares in the future

When the EBRD or IFC takes an equity stake it expects an appropriate return on its investment. It will have a clear exit strategy and will only take a minority position

- The terms and conditions of investment in a particular project will depend on the risks and anticipated returns of the project
- They do not seek or take a controlling interest in or direct responsibility for managing enterprises
  - IFC investment terms will usually provide for a put option for the sponsor
- The EBRD will not take long-term stakes
- The IFC can make long-term investments of 8-15 years, but the exit strategy must be defined up front
  - Public listing is the preferred exit mechanism

ofcf/Page 39

The EBRD Requires a Detailed, Thought-out Business Plan

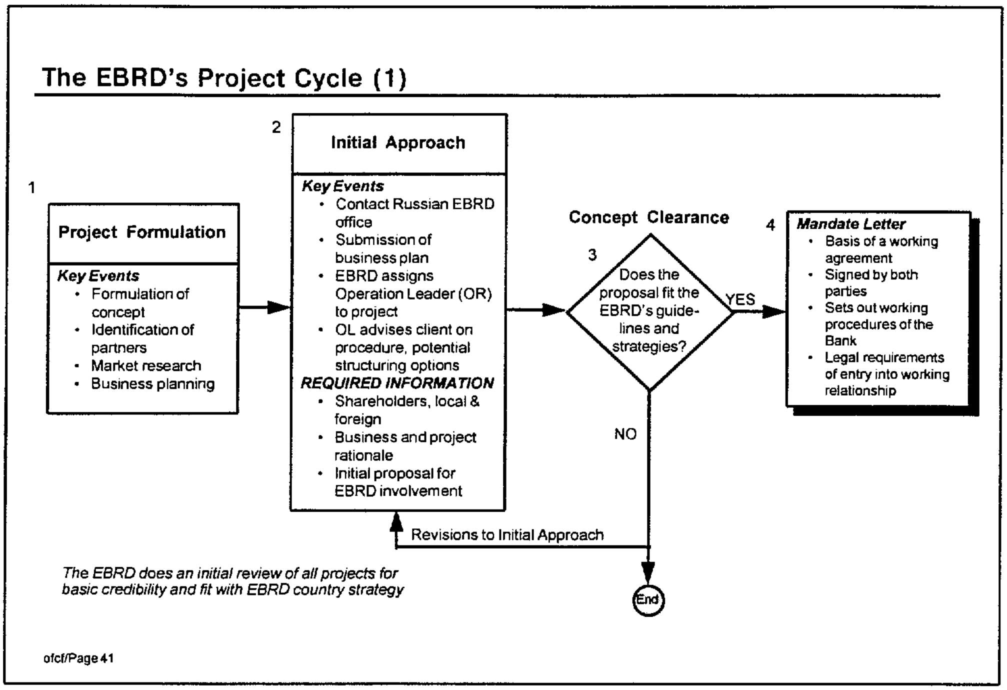
Companies seeking private sector development financing from the EBRD should be prepared to submit:

- A **Business Plan** which includes
  - A brief historical and current description of the company
  - What the company plans to become during the term of the proposed loan
    - Products
    - Management
    - Marketing
    - Production facilities
  - An Investment Plan which
    - Focuses on the investment program, including its total cost
    - Describes what the company will do with the proceeds of the loan
    - Details what machinery will be purchased and where it will be installed
    - Includes a detailed financing plan which spells out the timing of all financial requirements, and how each will be met

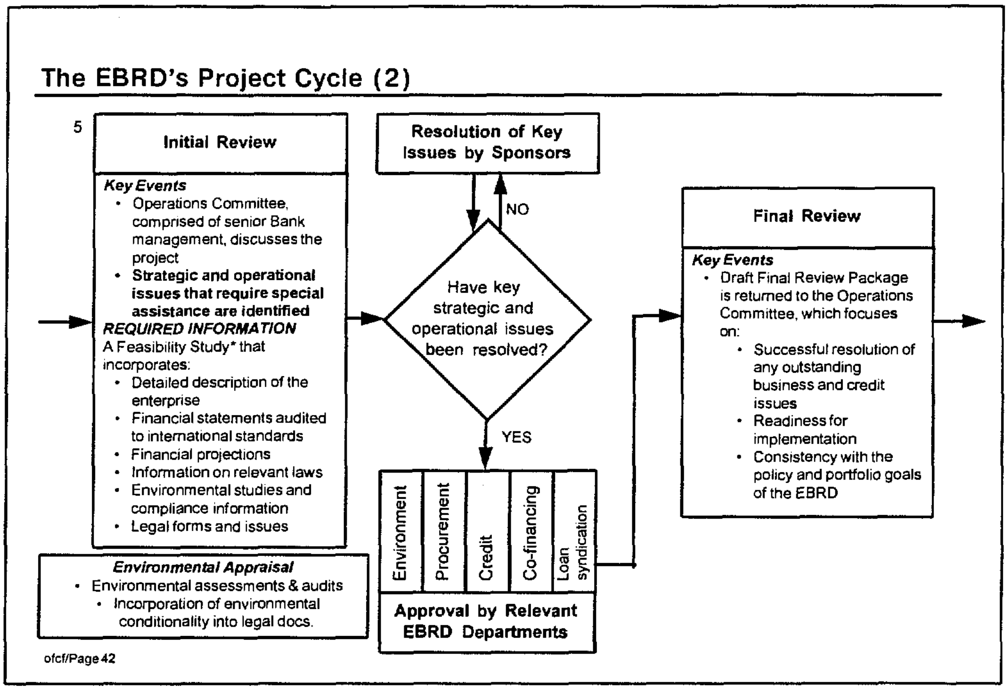
A detailed template for an EBRD business plan has been provided separately

ofcf/Page 40

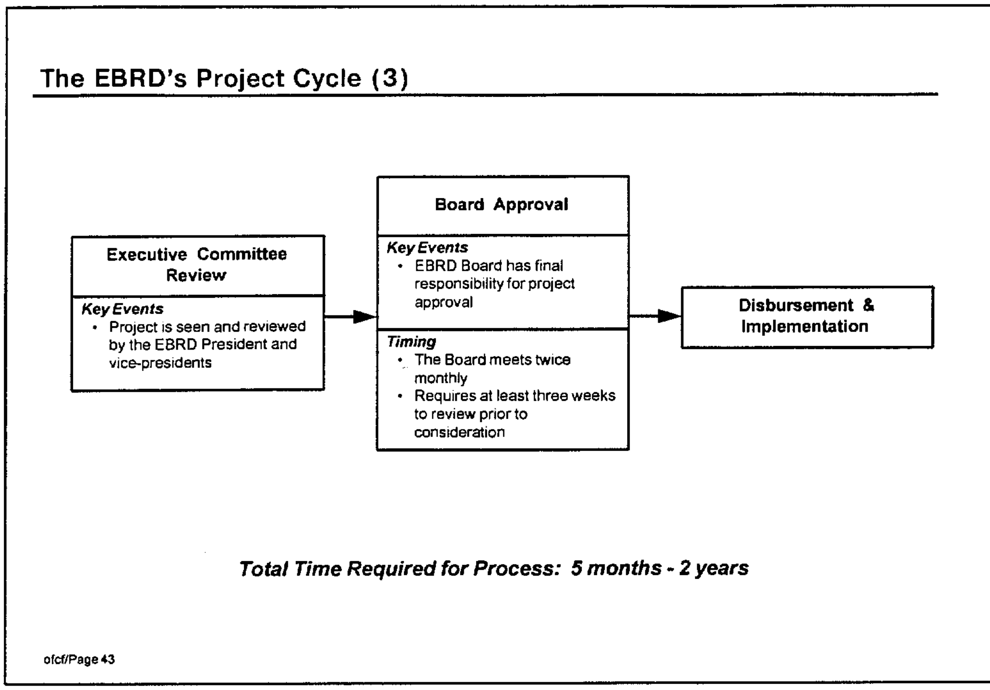
- A handout EBRD business plan template is included in the module, and should be handed out to participants at the beginning of the section on ILA Financing



- It is not necessary to go through the details of these process slides. They are meant to give an understanding of how complicated and arduous the EBRD's project cycle is
- The main point here is that the EBRD does an initial review of all projects for basic credibility *and* fit with EBRD country strategy



- There are two things worth pointing out here:
  - There is a rigorous environmental component to the review process
  - The multitude of required approvals, each of which can lead to changes in the project, and delays in the process



- Stress that 5 months is rare for wrapping up a project. 1.5 to 2 years is much closer to the norm.

The IFC Requires a Detailed Investment Proposal

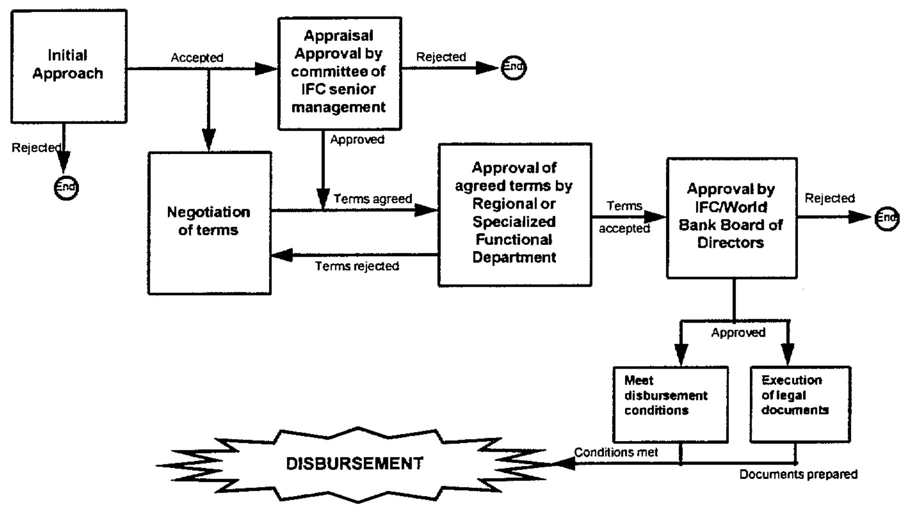
Companies approaching the IFC should prepare an investment proposal containing the following preliminary information:

- Brief description of the project
- Sponsorship, management and technical assistance:
- Marketing and sales:
- Technical feasibility, manpower, raw material resources, and environment:
- Investment requirements, project financing, and returns:
- Government support and regulations:
- Timetable envisaged for project preparation and completion

A detailed template for an IFC investment proposal has been provided separately

- An IFC Investment proposal template is included with this module and should be handed out to participants at the beginning of the ILA Financing section

The IFC Project Cycle is Slightly Less Complicated than the EBRD's



ofcf/Page 45

The Overseas Private Investment Corporation (OPIC) is a United States Government Agency Supporting Private Sector Development in Russia

OPIC assists American investors through 4 main investment promotion activities:

- Financing projects through loans and loan guarantees
- Supporting private investment funds
- Insuring investments against a variety of political risks
- Outreach activities designed to inform the American business community of investment opportunities overseas

OPIC is a self-sustaining agency. However, all of OPIC's financing and insurance obligations are backed by the full faith and credit of the United States of America

As a U.S. Government entity, there are a number of guidelines to which OPIC adheres:

- Projects must demonstrate a potential for positive effects on the U.S. economy
- Projects must be responsive to the development needs of the host country, and they must foster private initiative and competition
- Projects may not include "trade-related" performance requirements
- Projects may not have a major adverse impact on the environment of the host country
- OPIC will not support projects that contribute to violations of internationally recognized worker rights
- Financing is not available for projects that can secure adequate financing from commercial sources

ofcf/Page 46

321

The Overseas Private Investment Corporation (OPIC) is a United States Government Agency Supporting Private Sector Development in Russia (continued)

- "Positive effects on the U.S. economy" are measured by weighing balance of payments and employment effects of the project. Also:
  - level of U.S. procurement
  - net financial flows
  - net project exports to the U.S.
  - no "Runaway Plants" that is, the substitution of existing U.S. facilities with a foreign plan to produce for the same U.S. or export markets
- Trade related performance requirements refer to requirements covering local content and maximum import and minimum export levels, where the effect is to reduce U.S. trade benefits that would otherwise accrue

ofcf/Page 47

Investment is the Key Element of any OPIC Project

OPIC Financing and Insurance is only available for projects that involve equity investment by a U.S. company. This investment can take a number of forms:

- Types of project
  - Greenfield investments
  - Privatization
  - Expansion and modernization of existing plants
  - Acquisitions of existing operations if the investor contributes additional capital for modernization and/or expansion
- Types of investment
  - Conventional equity investments and loans
  - Construction and service contracts
  - Production sharing agreements
  - Leases
  - Various contractual arrangements such as consigned inventory, licensing, franchising, and technical assistance

There is no requirement that the foreign enterprise be wholly-owned or controlled by U.S. investors, but only the portion of the investment made by the U.S. investor is insurable by OPIC

OPIC Project Finance

Eligibility Requirements

- The U.S. investor is expected to assume a meaningful share of risk, generally through the purchase of at least 25% of the equity of the project
- Majority ownership of the foreign enterprise must be private, or government-owned enterprises may agree contractually to allow management to remain in private hands
  - Enterprises wholly-owned by a foreign government are not eligible

OPIC Participation

- OPIC can participate in up to 50% of the total costs of a new venture, and somewhat more in the case of expansion of a successful existing business

Financing Techniques

- ***Direct Loans*** are available for projects sponsored by U.S. small businesses or cooperatives
  - Generally between $2 million to $10 million
- ***Loan Guaranties*** are typically used for larger projects, and range in size from $10 million to $200 million
  - Guaranties are issued to U.S. financial institutions more than 50% beneficially owned by U.S. citizens, corporations, or partnerships

ofcf/Page 49

OPIC Project Finance (2)

OPIC Lending Terms

- Interest rates on direct OPIC loans vary with OPIC's assessment of the financial and political risks involved
  - They will also reflect interest rates in long-term capital markets in the U.S.
- Interest rates on OPIC-guarantied loans are comparable to those of other U.S. government -guarantied issues of similar maturity
- For loan guaranties, OPIC charges the borrower a guaranty fee which typically averages 2.5% to 5% per annum on the outstanding principal amount
  - In some cases, OPIC will adjust its guaranty fee to include an income-sharing provision
- The repayment schedule of direct or guaranteed loans will reflect the purpose of the loan and the projected cash flows to be generated by the project
  - This typically results in a final maturity of 5 to 15 years, following a suitable grace period when only interest is payable
- Up-front, commitment, and cancellation fees are charged
- Reimbursement is required for related expenses, included fees for outside counsel and experts or consultants

OPIC Application Procedures

The sponsor of a potential project interested in obtaining OPIC financing should:

- Submit OPIC Form 115 -- "Preliminary Application for Financing"
- Submit a business plan for the proposed project, which includes:
  - A general description of the project
  - Identity, background, and audited financial statements of the project's proposed principal owners and management
  - Planned sources of supply, anticipated output and markets, competition, and the basis for projecting market share
  - A summary of project costs and anticipated sources of procurement of capital goods and services
  - A proposed financing plan, including the amount of the proposed OPIC participation, and financial projections
  - Pro forma financial statements of the proposed project and accompanying assumptions
  - A brief statement of the contribution the business is expected to make to local economic and social development

ofcf/Page 51

OPIC Application Procedures (2)

- The data prepared and submitted by sponsors to substantiate sources of raw material, technical feasibility, and market demand are carefully analyzed together with the financial forecasts
- Following OPIC's preliminary review and approval, the sponsors may be asked to provide additional economic, financial and technical information as a formal application for financing
  - OPIC officers will provide guidance, as the type of information required will vary with the nature of the proposed business
- Final approval is required by the OPIC board
- Length of process varies, but a key determinant is the thoroughness and timeliness with which all required information is developed and submitted
- OPIC normally requires a completion agreement in which sponsors guarantee payment of debt service to OPIC as well as coverage of cost overruns

The fundamental selection criteria are:

- Economic, technical, marketing and financial soundness
- Adequate cash flow to pay all operational costs, to service all debt, and to provide owners with an adequate return on their investments

ofcf/Page 52

OPIC also Provides Political Risk Insurance

Political risk insurance can be a key factor in winning foreign commitment to a major investment project

OPIC insures U.S. investors, contractors, exporters and financial institutions against the following three political risks:

- Currency inconvertibility
- Expropriation
- Political violence

OPIC also has specialized insurance programs for:

- Financial institutions
- Leasing arrangements
- Oil & gas projects
- Natural resource projects
- Contractors and exporters

The Multilateral Investment Guarantee Agency also Provides Political Risk Insurance to Foreign Investors

The Multilateral Investment Guarantee Agency (MIGA) is . . .

- A member of the World Bank Group created in 1988 to enhance the flow of private investment into developing countries
- It is designed to encourage investment by filling gaps in investment insurance against non-commercial risks in developing countries to make investment opportunities in those countries more competitive with alternatives in industrial countries
- Affiliated with, but financially independent of the World Bank
- Has a capital stock of SDR 1 billion

MIGA provides two core services:

- ***Political Risk Insurance*** to foreign private investors against the risks of currency transfer, expropriation and war and civil disturbance in developing countries
- ***Technical Assistance*** and advisory services to developing member countries on means to promote private investment in their economies

ofcf/Page 54

OPIC and MIGA Political Risk Insurance is Available Against Three Types of Risk

Currency Transfer

- Protects against losses arising from the investor's inability to convert local currency returns into foreign exchange for transfer outside the host country, specifically:
  - Excessive delays in acquiring foreign exchange caused by host government failure to act
  - Adverse changes in exchange control laws of regulations
  - Deterioration in conditions governing the conversion and transfer of local currency
  - Currency devaluation is ***not*** covered

Expropriation

- Protects against acts by the host government which may reduce or eliminate ownership of, control over, or rights to the insured investment

War & Civil Disturbance

- Protects against damage to or destruction of assets caused by war or civil disturbance in the host country

ofcf/Page 55

The U.S. Trade & Development Agency Provides Grants to Cover Feasibility Studies

The U.S. Trade & Development Agency (TDA) is an independent U.S. Government Agency which:

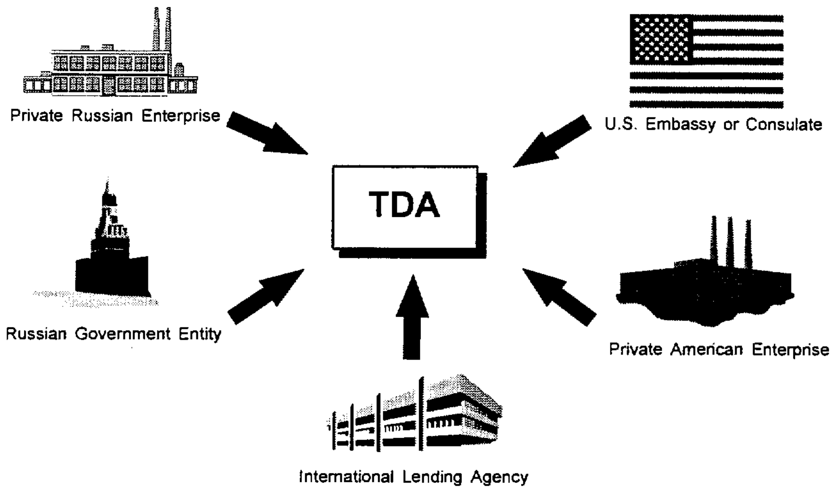
- Provides funding, in the form of grants, for ***feasibility studies*** of major projects
- These studies determine the technical, economic, and financial feasibility of the projects, and provide detailed data for making decisions on how to proceed with project implementation

Under TDA projects, a U.S. contractor is selected by the Russian Grantee to carry out the feasibility study

- No funds are transferred directly to the Russian Grantee
- The contractor's invoices are submitted to the Grantee, who approves them and forwards them to TDA

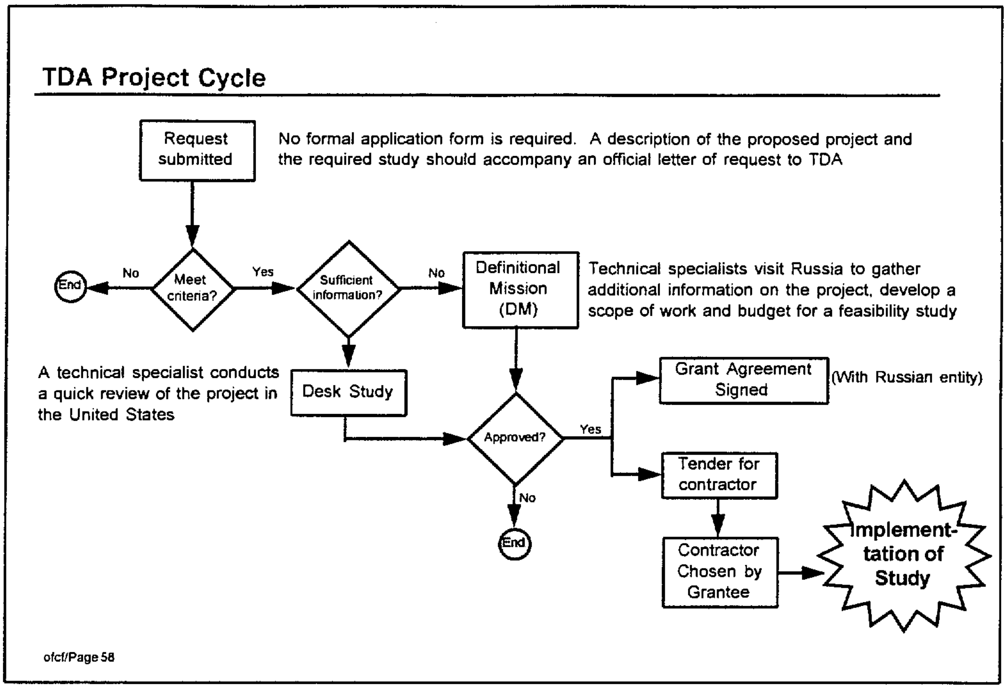
ofcf/Page 56

Potential Projects May Come to TDA's Attention in One of Several Ways



ofcf/Page 57

332


TDA Project Cycle
Request submitted
No formal application form is required. A description of the proposed project and the required study should accompany an official letter of request to TDA
End
No
Meet criteria?
Yes
Sufficient information?
No
Definitional Mission (DM)
Technical specialists visit Russia to gather additional information on the project, develop a scope of work and budget for a feasibility study
A technical specialist conducts a quick review of the project in the United States
Desk Study
Approved?
Yes
No
End
Grant Agreement Signed
(With Russian entity)
Tender for contractor
Contractor Chosen by Grantee
Implement-tation of Study
ofcf/Page 58

323

TDA Selection Criteria

TDA uses several key criteria to select projects in Russia

- All projects must represent a development priority for Russia
- Financing for the project should be identified
- TDA must play a facilitating role
- There must be significant potential for U.S. exports during project implementation
  - In Russia, TDA will only consider projects with potential U.S. exports of ***at least $10-15 million***

TDA has developed a list of high priority sectors for its activities in Russia

- Oil & gas
- Power plants
- Distribution networks
- Transportation infrastructure
- Defense conversion
- Electronics

ofcf/Page 59

Summary - How to Use this Information

Getting finance from international lending institutions can be a difficult process

- It is not worth undertaking unless you can be fairly sure that your investment project is an appropriate candidate
- In any case, you need to think carefully about which ILA, if any, is right for you

You have been provided with a decision support tool that should help you answer these questions

- The tool is a set of simple questions
- Your answers will help you identify the correct source of financing to approach

The tool does not provide a final answer. It only helps you think about how your resources should be prioritized.

Any questions regarding any of the ILAs discussed here are best answered by the ILAs themselves. A full list of contacts will be provided to you.

ofcf/Page 60

Business Plan for the
European Bank for Reconstruction and Development

Submitted by "Company Name"

Month XX, 19XX

PART ONE - OPERATIONAL AND STRUCTURAL OVERVIEW

I. DESCRIPTION OF THE COMPANY

History

- When was the business founded? Who were the founders?

Corporate Structure and Organization

- What is the corporate structure: partnership, joint stock company?
- If there are shareholders, indicate how many and whom.
- How are shareholders represented in a Board of Directors?
- Who are the senior management and the most important line management?
- What is the management structure?
- Will additional line management be needed as a result of the investment program?

Current and Historical Financing Arrangements

- What, if any, have been all external sources of equity or of debt?
- How much of any equity or debt provided by third parties currently exists?
- Is there a JV with a foreign partner? If so, provide the JV contract.

Human Resources

- How many employees does the company employ?
- Are there any planned redundancies?
- What are the company's principal labor unions?
- What is the unions' involvement in the management of the company?

II. THE PRODUCT

Product Line

- What are the company's products? These should be spelled out in detail, with technical specifications for each.
- On which products will the investment program focus?

Sourcing Strategy

- What are the major inputs required for production?
- Who are the principal supplier? What proportion of inputs do they supply?
- What are the terms of payment to suppliers?
- Are these major suppliers private companies? State-owned companies? Will they be privatized in the short-term? Will there be any other such corporate event that may disrupt supply?
- Are there long-term contracts with these supplier? At fixed price?
- What alternative suppliers exist? What would be the cost of switching sources of supply?

Production Strategy

- How, in layman's terms, does the production process work?
- Provide a description of the principal production facilities and their respective functions.
- What level of stocks of unfinished goods are normally kept -- as a percentage of sales? What levels of wastage of such stocks occur?
- What, if any, patents or licensing agreements exist with reference to particular products

III. COMPETITIVE POSITION

Target markets

- What are the company's principal markets, including the specific sub-markets for important individual product lines? Which companies are the major customers?
- What were export sales? Where are the principal export markets? Which product lines are the most important contributors to export sales?
- Does the company have any large single customers?

Competition

- Who are the company's chief competitors?
- Which, if any, new competitors will arise as a result of the proposed investment program?
- From which competitors does the company propose to take market share, and how?
- How do they company's products compare to those of their competitors? Are they less expensive, better (if so, in what way better), have they more flexible production schedules?

IV. MARKETING AND SALES

Marketing Strategy

- How are products marketed? Through one or more wholesale distributors, or by the company's own salesforce?
- Is distribution done differently for different product lines?
- How does this compare with the industry norm?
- How many people work on marketing, and how are they organized?
- How will salespeople be compensated? By what combination of salary and commission? Why has this structure been chosen?

Pricing and Promotion Strategy

- How are products priced? How will new products be priced?
- What other inducements are offered to customers, e.g. service contracts, warranties?
- What, if any, promotional plan will be used to introduce new product into the market?

V. PRODUCTION FACILITIES

Existing Production Strategy

- What are the company's current production facilities?
- Specify which production facilities are used for which products, for example:

Plant 1	Die casting
Plant 2	Die casting
Plant 3	Gear manufacturing
Plant 4	Gear manufacturing
Plant 5	Low density cables
Plant 6	Warehosing/distribution center

- Show the approximate workforce employed at each.

- Show the date of construction of each facility, noting redevelopment dates where significant
- Provide a short general explanation of the production processes employed:
  - What are the basic raw materials?
  - From where are these sourced?
  - Is unfinished product moved from one facility to another?
  - Are any other companies involved in intermediate stages of production?
  - What is the time schedule from raw material to finished products?
  - At what percentage of available capacity are plants currently operating?
- What other assets does the company have? What is the value of these assets?
- What additional capital expenditure requirements, not associated with the proposed investment program, will occur over the term of the funding?

VI. IMPACT OF THE PROPOSED INVESTMENT PROJECT

Impact on Current Operations

- In the context of the production process described above, what is the investment project?
- Will new production facilities be build? What role will they serve in the production process?
- Which existing facilities will be altered? Describe proposed alterations to each facility in turn.
- How will any of the characteristics of the process as described above be changed?
  - Changes to the amount of vertical integration?
  - Changes in production capacity?
  - Changes in time schedule for stages of the process?
  - Changes in the start-to-finish time schedule?
  - Alleviation of any production bottlenecks?
- How many new staff will be required to work new facilities?
- How many existing staff will be re-employed?
- What training will be necessary, and how long is it expected to take?

PART TWO - FINANCIAL OVERVIEW

I. FINANCIAL HISTORY

- Provide annual profit and loss statements for the last 2 years.
- Provide an estimate of the annual profit and loss statement for the current year.
- Provide balance sheets for the last 3 year-ends.

This information can be provided in local format, but should additionally be provided in Western format if available.

II. INVESTMENT PLAN

Investment Program

- Provide a detailed breakdown of the proposed investment program and the time schedule for its implementation.
- How do all costs divide between local currency and foreign currency?

Equipment Plan

- Provide an itemization of all equipment to be purchased and all other costs, such as construction costs, etc.
- Who are the equipment manufacturers in the case of each item of machinery to be purchased?
- On what basis have these manufacturers been chosen? What was the relative importance of cost, reliability, post-sale service in deciding upon the equipment supplier?
- Has equipment been sourced from this supplier in the past?
- What is the supplier's local presence in terms of service, provision of any necessary training or consultancy, spare parts and repair?
- At what stage are the conclusion of equipment suppliers' contracts? What are the proposed (actual) terms of payment?
- What are the relevant customs charges on each item of imported equipment?
- What capital allowances chargeable against tax are being given? What is the tax depreciation schedule of the equipment?

III. FINANCING PLAN

- Show in tabular format the timing of expenditures related to the investment program and the corresponding timing requirement for financing.
- What are all the sourced of financing for the project? Show equity funding, all sources of domestic funding, and all sourced of foreign currency funding.
- Indicate clearly the amount and required timing of funding from the Agency Line

IV. FINANCIAL PROJECTIONS

- Show full cash flow projections fro the proposed funding term. These should be prepared on a quarterly basis for at least the first year of forecasts, and on an annual basis thereafter.
- Pay particular attention to revenue forecasts.
- For companies with existing revenues, revenues generated by on-going production facilities should be identified separately from those generated as a result of the investment program.
- Revenue forecasts should, in any event, be constructed "from the bottom up:" units of production should be forecast for all major product lines, and prices separately forecast and applied to unit forecasts.
- Cost forecasts should be similarly detailed: Costs of Goods Sold should be identified for all major product lines, and major fixed costs separately identified.
- Working capital requirements should be separately forecast.
- All cash flow forecasts should also include a proposed schedule of interest payment and debt repayment.
- All assumptions contained in the cash flow forecasts should be explicitly stated on a separate sheet: annual increase in unit sales, annual increase in unit price, increase in number of employees, increase in wage cost per employee, inflation rate, etc.

Source: Business Plan Outline & Agent Bank and Investment Fund Contact Information, EBRD, Office of the U.S. Executive Director

Investment Proposal to the International Finance Corporation

Submitted by "Company Name"

Month XX, 19XX

I. INTRODUCTION

A brief description of the project

II. SPONSORSHIP, MANAGEMENT AND TECHNICAL ASSISTANCE

A. Project Sponsors

- **Sponsor #1**

History and business

Financial information

- **Sponsor #2**

History and business

Financial information

- **Sponsor #3**

History and business

Financial information

B Management Structure

Proposed management arrangements

Names of proposed managers (CVs in appendix)

C. Technical Assistance

Description of technical arrangements and other external assistance

III. MARKET AND SALES

A. Market Positioning

Basic market orientation -- local, national, regional, or export

B. Sales Strategy

Projected production volumes, unit prices, sales objectives, and market share of proposed venture

C. Distribution Strategy

Potential users of products and distribution channels to be used

D. Competitive outlook

Present sources of supply for products.

Future competition and possibility that market may be satisfied by substitute products

E. Legal factors

Tariff protection or import restrictions affecting products

IV. TECHNICAL FEASIBILITY AND ENVIRONMENTAL FACTORS

A. Production Strategy

Brief description of manufacturing process

Comments on special technical complexities and need for know-how and special skills

Possible suppliers of equipment

Availability of manpower and of infrastructure facilities (transport, communications, power, water, etc.)

Proposed plant size in comparison with other known plants

Breakdown of projected operating costs by major categories of expenditures

B. Sourcing Strategy

Source, cost and quality of raw material supply and relations with support industries

Import restrictions on required raw materials

Proposed plant location in relation to suppliers, markets, infrastructure and manpower

C. Environmental Issues

Potential environmental issues and how these issues are addressed

V. INVESTMENT REQUIREMENTS, PROJECT FINANCING AND RETURNS

A. Project Costs

Estimate of total project cost, broken down into land, construction, installed equipment, and working capital, indicating foreign exchange component

B. Financing Strategy

Proposed financial structure of venture, indicating expected sources and terms of equity and debt financing

Type of IFC financing--loan, equity, or both, and amount

C. Financial Projections

Projected financial statement, information on profitability, and return on investment

Critical factors determining profitability

VI. GOVERNMENT SUPPORT AND REGULATIONS

A. Government Support

Project in context of government economic development and investment program

Specific government incentives and support available to the project

Expected contribution of the project to economic development

B. Legal Issues

Outline of government regulations and conditions of capital entry and repatriation

VII. TIMETABLE

Timetable envisaged for project preparation and completion

Selected References
Obtaining Finance Module

Cash Flow

- Corporate Finance. Stephen A.Ross, Randolph W.Westerfield. Times Mirror/Mosby College Publishing
- Financial Management (Theory and Practice) 7-th edition. Eugene F.Brigham, Louis C.Gapenski. The Dryden Press, Harcourt Brace College Publishers

Net Present Value (NPV)

- Financial Management (Theory and Practice) 7-th edition. Eugene F.Brigham, Louis C.Gapenski. The Dryden Press, Harcourt Brace College Publishers
- Corporate Finance. Stephen A.Ross, Randolph W.Westerfield. Times Mirror/Mosby College Publishing

Discount Factor

- Financial Management (Theory and Practice) 7-th edition. Eugene F.Brigham, Louis C.Gapenski. The Dryden Press, Harcourt Brace College Publishers
- Corporate Finance. Stephen A.Ross, Randolph W.Westerfield. Times Mirror/Mosby College Publishing

Company Valuation

- Mergers, Restructuring, and Corporate Control. J.Fred Weston, Kwang S.Chung, Susan E.Hoag. Prentice-Hall, Inc.
- Guide to Business Valuations, 2-nd edition. Jay E.Fishman, Shannon P.Pratt, J.Clifford Griffith, D.Keith Wilson. Practitioners Publishing Company

Leasing

- Corporate Finance. Stephen A.Ross, Randolph W.Westerfield. Times Mirror/Mosby College Publishing

Additional readings and reference materials

- “Основы анализа финансовой, хозяйственной и инвестиционной деятельности предприятия”. Специальный выпуск. А.Е.Абрамов. АКДИ “Экономика и жизнь”, 1994
- Справочник “Кто есть кто на российском рынке ценных бумаг”. М. АО AK&M, АО “Московские новости”, АО “Авиаиздат”, 1995.