DPR AND BANK CREDIT

The health of a business is measured by its financial performance and the investors will always make their decision based upon the financial statements of the business. This makes it imperative for the owner of a business to be financially literate. The financial literacy, so to say, will go a long way in boosting the confidence of the entrepreneur and take strong decisions based on careful and fundamentally strong analysis of financial implications of such decisions on the future of the business.

There are few key insights which any budding entrepreneur must be aware of beyond his product and market. These include cash management, vendor and invoice management, cost analysis, financial statement analysis, funding for capital acquisition, working capital management etc. In fact many times the business has to explain the financial parameters to partners, employees, investors and lenders. Although an accountant can be hired for these tasks but if the entrepreneur understands these concepts, he will always be in better control of affairs. And many times, especially during the initial days, hiring the accountant would be difficult.

DPR AND ITS SIGNIFICANCE

One of the key documents prepared by an entrepreneur to discuss the business idea with the investors and proposed partners is called the Detailed Project Report or the DPR. It contains all details of the product/service, target market, delivery process, team, viability, marketing plan and financial analysis. These are subjective and their impact assessment needs numbers or quantification which is found in the financial section of this plan. The detailed project report submitted to the investors or lenders has this important component of financials which reveals the financial feasibility of the project. The finance part of the business plan holds key significance as it forms the key fundamentals for an investor to decide upon investing in the business. Even if no outside funding is required, it is necessary to understand the financial performance of a business through the numbers. Many entrepreneurs might not be too proficient in making or understanding these statements as they need understanding of basic accounting procedures.

Readymade templates come in handy for those who cannot afford to hire accountants but still a basic understanding of key elements and ratios is important.

One must not confuse financial projections with accounting as there we extract financial statements from our past record of financial transactions. These days, financial accounting software does that very easily. However, in a project report we need to look forward rather than backward and that always involves risk due to uncertainty. It is called as forecasting and while we do not waste much time in minute details of these forecasts, it is essential that vital details or items are not left out. At the end of the day, these are projections and not likely to be too accurate with respect to the actual but the deviations should not be drastic as otherwise it will erode the confidence about the business and its management team. One should be very careful about revenue forecast and capital investment as they might derail the entire business model. The angel investors or venture capitalists look at these numbers carefully to see the risk-return tradeoff provided as well as deciding upon the exit time frame. These numbers also act as guidance for the entrepreneur as he knows what his business needs to achieve over a period of time.

CONTENTS OF DPR

As already explained above, the DPR is a comprehensive document made with the purpose of establishing the credit-worthiness of a firm. It contains details about the following components of the project and the firm.

Promoters' Details

This is the basic information as it introduces the customer to the bank. This part would normally include the following details:

Promoter's qualification: This gives an idea about the academic or professional background of the promoter. If a borrower is technically qualified, it always adds weight to his credentials

Experience: Having experience in similar lines of business is a great asset which gives confidence to the lender. The DPR should highlight all the details about the past experience of the applicant with all key details.

Legal history: The legal identity of the business and how it has evolved over the time should be mentioned. If it is a new firm, then the organization form should be clearly mentioned along with the promoter details. In case there are any litigation issues with the firm, the banker/lender may enquire about them also.

Ownership: The ownership of the business with personal details about the promoters (proprietor, partners, shareholders etc) should be clearly spelt out in this section. The bank will ask for the Net Worth of all the promoters which would be determined on the basis of their assets and liabilities. Their personal creditworthiness may also be looked into and any adverse record of past financial transactions may hamper the possibility of funding.

Past performance: For an existing business, the past performance becomes a critical measure of evaluation for a new credit facility. The DPR should highlight the key past achievements of the business financially as well as in other parameters like R&D, distribution network, market share, strategic advantages etc.

Technical Details

This section of the DPR would explain all the technical details about the following aspects:

Product: This section should describe the product in detail- the technical details as well as its utility. It should also state why it has been chosen i.e. whether the firm enjoys any USP related to the product.

Manufacturing Process & Technology: The DPR should have a detailed explanation about the manufacturing process including sourcing of raw material, machinery used, plant layout and the technology used. It is required to furnish other details regarding the machinery proposed to be used along with its sourcing.

Market & Industry Details

This is an important segment as bankers will look at this in great detail. The market research based upon authentic secondary data should be placed in this section.

Size of the industry: The industry size determines the opportunities available in a market while the growth rate for the last few years will indicate the future prospects. Based upon these inputs, an estimation of long term growth prospects should be mentioned.

Market segmentation: The customer segment for the product needs to be defined to enable the lender to assess the product positioning. In case there are multiple segments for the product based upon a differentiator like price, then the segment of this market targeted by the firm needs to be described.

Competition: The report should indicate the present level of competition in the product along with the names of competitor and their market share. The firm's competitive advantage, if any, should be explained.

Project Cost and Finance Structure

This part is the introduction to the financial component of the project. At the outset, we describe the project in a nutshell indicating the total cost of the project and its sources.

Capital Expenditure: This relates to information about the amount of investment in fixed assets or long term assets like building, plant & machinery, furniture and fixtures, vehicles etc. This investment has to be made out of term loans from the bank.

Working Capital: This relates to requirement of revolving fund or funds for the short term like purchase of raw material, financing of debtors (arising out of credit sales), holding of stock etc. The bank will sanction a cash credit limit for the purpose.

Sources of Funding: After we have estimated the total cost of the project, we need to disclose the proposed source of funds for the same. The bank will usually ask for a margin to the extent of 20% to 25% for both the term loan and working capital. The source of margin money needs to be mentioned for sake of clarity.

Financial projections and ratios

This segment is crucial as the lending decision and the quantum of financing is dependent on the figures mentioned here. By projections we mean estimates about future periods.

These should be based on certain assumptions which also need to be presented as assumptions for calculation.

Projected Income Statement: The income statement is a record of all items of revenue and expenses and is a critical statement showing profitability of the business at various levels. It is also called as Profit and Loss account. The projected income statement shows the future estimates of revenue and expenses. The future sales figure is a key indicator of the firm's ability to pay the debt so this has to be made very carefully. Similarly all the direct and indirect expenses should be estimated. The projections are to be made for the entire period of the loan repayment.

Projected Balance Sheet: The Balance Sheet shows the scale of a business and has a record of all assets and liabilities. As the business grows, the size of the balance sheet increases. It shows the source of funds and their utilization. This statement is also very significant and the projected balance sheets are to be shown in DPR for the entire term of the loan.

Projected Cash Flows: The cash flow statement are important to find the outflow and inflow of cash under various types of activities and is a good measure of how a business manages cash and hence pays for its operating expenses as well as periodic debt repayments. This statement is also required for the entire projection period.

Key Ratios: The financial ratios are indicators of the financial health of a company. They are derived from the income statement and balance sheet. These ratios are used to comment on the profitability, liquidity, operating efficiency and long term solvency of the firm. The ratios are normally compared to industry averages to find whether they are under acceptable limits. Some of these key ratios have been discussed later in this chapter.

FINANCIAL INFORMATION IN DPR

The following are the main components of the financial information in the DPR:

1. Cost of project

Overall financial layout of the project

2. Means of finance

Sources of Funding- Self Contribution plus bank finance/other sources

3. Assumptions for cost and sales

The basis for unit cost and unit sales

4. Projected income statement

Forecast of items of revenue and expenses for a particular time

5. Term loan repayment

Repayment schedule of the term loan during the loan tenure

6. Depreciation on fixed assets

Rate and schedule of deprecation of fixed assets

7. Balance Sheet (past and projected)

Statement of Assets, Equity and Liabilities

8. Cash flow statement

Inflow and outflow of cash under operating, investing and financing activities

9. Debt service coverage & other key ratios

Ratios to analyze profitability, liquidity and solvency

10. Break Even Analysis

The no profit-no loss level of operations

Sensitivity analysis

This is a risk assessment technique where an investigation regarding impact of change in key variables in future is observed. For this we look at various probable scenarios in future where either there is a decline in revenue or increase in expenses (like unexpected

increase in the cost of raw material). Based upon these, we see how sensitive the return on investment is due to change in any of these critical factors.

Risk analysis and mitigation

The report should contain a section on risk assessment which has details on the risk exposure to the business. The risks may be financial, operational or economic depending upon the nature of the industry. Along with the probable risks, the strategy to manage those risks should be explained.

Competitive analysis

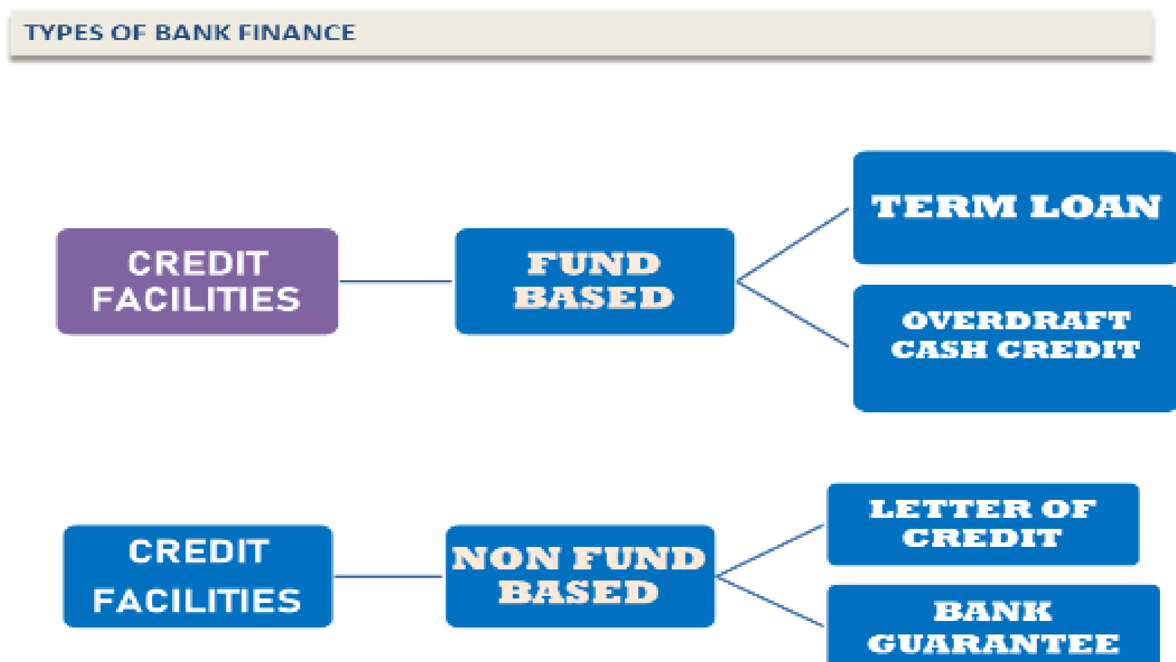
In big projects, there might be a section on competitor analysis which describes present and possible competitors, impact of competition and strategy to face it.

SWOC Analysis

Strengths, Weaknesses, Opportunities and Challenges related to the business may be explained in this section. This is also prepared only in case of large projects.

TYPES OF BANK CREDIT

Bank provides credit facilities under two broad categories- fund and non fund as under:



The fund based facilities are those which involve transfer of fund to the borrower. On the other hand, non fund based facilities are those in which the bank provides undertakings on behalf of the borrower.

The fund based facilities are normally of the following types:

a. **Term Loan:** As the name suggests, it is a credit facility granted for a term. It is used to finance fixed or long term assets like building, plant & machinery, furniture and fixtures, vehicles etc. The bank will ask for price quotations from a reliable source to verify the cost. The useful life of the asset will determine the tenure of the loan. The bank will fix the repayment schedule as per the nature of business which usually is on a monthly basis. Delayed repayment may invite penal interest as well as change the classification of loan. The disbursement of the loan will be by way of direct fund transfer in the name of the seller of the concerned asset. The asset ownership will remain with the bank as primary security in the form of hypothecation or mortgage. The borrower has to bear the cost of insurance.
   - Term Loan assessment is done on the basis of projected cash flows which are dependent on earning capacity and life of the asset
   - Loan period is between 5 to 7 years which in some cases may go up to 10 years.
   - The decision is based upon calculation of Debt Service Coverage Ratio (DSCR) whose value should ideally lie between 1.5 to 2. This ratio has been discussed later in this chapter.

b. **Cash Credit:** This facility is used to fund the working capital requirements of the firm like purchase of stock, holding of finished goods, financing of debtors (credit sales) etc. The amount of working capital will be fixed on the basis of operating cycle, Normally it is taken as maximum of three months except in seasonal businesses or where there are heavy fluctuations. The limit is fixed and the borrower is allowed multiple debit (withdrawal) and credit (deposit) transactions within the sanctioned limit. The funds should be used only for authorized purposes and should not be diverted elsewhere. Interest is charged by the bank on the utilized amount only. It is a short term credit facility and needs to be renewed every year where you can request for enhancement or curtailment of the

limit as per needs of the business. The goods or debtors are hypothecated as primary security.

- Limits up to Rs.5 crores are normally assessed on the basis of turnover method.
- This method assumes CC limit requirement as 25% of the annual turnover.
- Bank will finance 80% of the assessed limit while the remaining 20% would be provided as margin. For example if the annual turnover is Rs.100 lacs, then the working capital required is Rs. 25 lacs. Of this Rs. 20 lacs would be provided by the bank as CC limit while the remaining Rs. 5 lacs will be brought in by the borrower as working capital margin.
- Operating Cycle may be used in case of seasonal businesses. (Operating Cycle refers to the time taken to complete one cycle from cash used to purchase raw material to cash realized from sales. Longer the duration of operating cycle, higher will be the working capital requirement.)

c. **Overdraft:** Sometimes, the borrower is in need of urgent funds and a formal sanction of additional funds through normal appraisal process may take a lot of time. In order to meet such exigencies banks allow withdrawal of funds beyond the sanctioned limit purely on the basis of merits of the case, past track record of the borrower and availability of security to cover the additional exposure. However, interest rates for this facility are high and it should be adjusted in short period of time.

The bank charges fee for non fund based facility (unlike interest for fund based facility) and collateral of equivalent amount needs to be provided. The most popular non fund based facilities are as under:

a. **Letter of Credit:** It can be described as a kind of guarantee of payment to the seller by the buyer's bank. It is issued by the bank on the buyer's request as its customer. This is used greatly in international transactions as the buyer and seller belong to different jurisdictions and to avoid risk of payment default, the seller demands it from the buyer. The bank will process this facility similarly like the fund based facility and demand security.

b. **Bank Guarantee:** This is a guarantee issued by the bank to cover the loss caused due to the default on part of the borrower. This default relates to non fulfillment of terms and conditions of the contract. It is normally sought from the bank by customers who are participating in any tendering process wherein bank guarantees are required to be furnished for being eligible to win the contract. It is similar to letter of credit except that while the LC is mostly used in international trade, BG is issued to the beneficiary as guarantee of performance while handling a contract.

THREE CRITICAL TESTS OF FINANCIAL HEALTH

In order to judge the financial health of a business, the lenders normally focus on three critical indicators- Liquidity, Profitability and Solvency.

1. **Liquidity**- This refers to the ability to convert assets into cash in order to meet financial obligations. It is mainly measured by the following ratios which are calculated from the Balance Sheet:

   a. Current Ratio: It is a measure of the number of times a firm owns current assets in proportion to its current liabilities. Current assets refer to those assets which would be converted into cash within a short period of time which is not

more than one year. Examples include stock and debtors. On the other hand, the current liabilities relate to those financial obligations which are repayable within a year like trade creditors. Higher value for this ratio indicates higher liquidity. Normally banks demand a current ratio of over 1.20.

Current Ratio = (Current Assets/Current Liabilities)

b. Quick Ratio: This is just another version of current ratio. However, we do not include inventory or stock as current assets in this case as sometimes; the stock might not be liquid enough (would be difficult to sell it on demand) and hence may not reflect the true liquid position of the business. A quick ratio of 1 is considered to be satisfactory by the banks.

Quick Ratio = (Current Assets less Stock/Current Liabilities)

2. **Profitability-** This refers to the ability to generate profit from operations. This is important as the business should have the capacity to generate sufficient profits to meet its obligations and generate returns for the investors. It is mainly measured by the following ratios calculated from the Income Statement and the Balance Sheet:

a. Net Profit Ratio: Also called as Net Margin, this ratio compares the amount of net profit (profit after tax) with total sales. It can be derived from the Income statement or the profit and loss account. The higher the ratio, the wider is the margin for the business and hence a higher return on investment. The minimum accepted level is the industry average.

Net Profit Ratio= (Net Profit/ Sales)

b. Return on Assets: This is another version of profitability ratio which looks at profits from the investment point of view and hence equates profit with total assets employed in the business.

Return on Assets = (Net Profit /Total Asset)

3. **Solvency** – This refers to long term stability of the business and is reflected by optimal mix of debt and equity in the capital**.** This is important to find out the capability of the business to honour its long term debt obligations. The two key solvency ratios are as under:

    a. Debt - Equity Ratio: This ratio describes the proportion of long term outside liabilities to the equity contributed by the owners. Since debt has to be repaid irrespective of how the business is performing, very high levels of debt are considered risky for long term sustainability of the business.
    Debt - Equity Ratio = (Total debt / Total Equity)

    b. Debt Service Coverage Ratio [DSCR]: This is one of the most important parameter used by the banks to decide upon the financial strength of a credit proposal. The term loan assessment depends upon this. In plain simple terms, it is a measure of how sufficient are the earnings of a firm with respect to its debt repayment obligations. Obviously, the higher the ratio the better are the prospects of the proposal being accepted by the bank.
    DSCR = (Net Operating Income /Total Debt Obligation)

KEY VARIABLES FOR BANK DECISION

After receiving the application for bank credit along with the DPR and supportive documents, the bank takes its decision to sanction or reject a credit proposal depending upon the merits of the case. The bigger the project, the more detailed is the appraisal process. Some of the key factors taken into consideration for taking the credit decision are outlined as under:

- **Prima Facie Acceptability**

This is the first step of due diligence undertaken by the bank. It involves looking at the application in light of Bank's / RBI / Government Rules and regulations, credit report on the firm as well as the promoters by looking at various Defaulter's List issued by RBI and

the exposure norms with respect to various sectors. Along with this the constitution of the applicant in terms of its legal structure, and obtaining of various regulatory licenses – like the Pollution Clearance Certificate is also checked. The application should also be accompanied with all required KYC documents. The bank may also collect market report about the existing businesses.

- **Technical Feasibility**

Selection and compatibility of Machines; Capacity of Machines – installed capacity and operating capacity; Input – output ratio of Raw Materials and Finished Products, Wastage, Availability of Raw Materials, Power, Water, Labour etc; Factory Layout and accessibility; Disposal of wastes and effluents

- **Economic Viability**

Demand & Supply; Preference of users; Competition; Techno Economic Viability Report

- **Financial Feasibility**

Cost of Project- Land & Land Development, Civil Constructions; Machineries; Furniture & Fixtures, Contingencies; Means of Finance: Bank Loan, Margin / Subsidy

- **Commercial Viability**

Profitability Study; Break Even Analysis; DSCR analysis

- **Managerial Competence**

In banking parlance the basic credit appraisal is centered around what are known as the 4Cs- Character (the track record and image of the borrower), Capacity (experience of running business & expertise in the concerned industry), Capital (the amount of capital being contributed by the promoter of the business and its sources) and the Collaterals (the amount and type of security on offer i.e. its value & acceptability).

- **Pre Sanction Inspection & Market Report**

The bank officials make a visit to the residential and office addresses of the applicants and guarantors where they verify their personal assets and liabilities which help them to arrive at their net means. They also collect inputs from the market which has a bearing upon the decision to sanction the credit facility.

IMPORTANT TIPS FOR BANK OPERATIONS

While dealing with the bank, many times business owners are either not aware of certain issues or become negligent due to which they might face problems in smooth banking operations. The following are few of the issues which should be taken into consideration:

Cash Credit Accounts

- The business should try to route maximum sale proceeds through account only which means that majority of the sale proceeds should be credited in the CC account. Even if cash sales are made, the same should be deposited in the account as it will provide evidence of sales and help you in putting your case for limit enhancement at the end of the year.
- Self drawn cheques are not allowed in Cash Credit Accounts.
- Do not overestimate your limit requirement in order to remain flush with funds. This may not be helpful; because underutilization of limit will lead to commitment charges being debited in the account.
- Cash Credit limit is assessed annually and it can be increased or decreased depending upon the sales and state of the business. Since renewal takes time for the bank officials as they have to process the entire application based upon the past year performance, it is advised to present all related documents well before expiry of the limit. This will ensure timely renewal.
- Audited financials are required for businesses with turnover more than Rs. 1crore. So, it is necessary to get the accounts audited before submitting to the bank.
- The business should maintain the books of stock updated all the time as the business premises are subject to inspection by the bank periodically. Upon inspection, if the stocks do not tally with the records, the bank may seek an explanation regarding the same.
- Debtors more than three months old are generally not accepted so the business unit should try to reduce their collection period. At the same time the record of debtors should be kept up to date.
- The biggest misconception among the CC limit users is that they have to only serve the interest which is charged at the end of every month. This highly reduces the

chance of enhancement of limit in the following years and also often assumed as diversion of funds by the bank. Hence, the transactions in the CC account should be carefully undertaken.

Current Accounts

- If you have a existing current account in another bank then obtain an NOC from the former to open a new current account in another bank.
- Apply for the cheque books at least 15 days in advance as they are printed with the accountholder's name.
- Avoid cash transactions in current account particularly of large size so that they are not reported as suspicious transactions.
- For small centres, inform bank branches in advance for any exceptional withdrawals as they keep cash at lower level to maintain cash retention.

Sample DPRs

As already discussed earlier, the scope of the DPR depends upon the scale of project. If the project is small, the DPR may be accepted by the bank with some bare essentials. However, if the scale of the project is big, the DPR needs to be made on an exhaustive basis as per the contents explained earlier. Some of the sample DPRs (for small projects) can be seen at**:**

http://niftem.ac.in/site/Internal_NIFTEM.aspx?menulevel=2&MenuID=143

http://iifpt.edu.in/ab-pmfme.php