CHAPTER I

INTRODUCTION
Rapid industrialization has been recognized as an important means for achieving socio-economic changes as set out in the Industrial Policy Resolutions from time to time. The nature, level and pace of industrialization is determined by a combination of factors like factor endowments, financial resources, technological capabilities, entrepreneurial talents and institutional setting.

As a part of necessary institutional infrastructure for provision of long term funds to supplement investor’s contribution besides implementing industrial policies and programmes of the government, specialized development financial institutions in the public sector have been set up in the country. Based on the objective of these lending institutions, which lend capital for purpose of industrial development has been termed as ‘Development Banks’ in this study. Identifying, developing and assisting new entrepreneurs, accelerating the process of industrialization of backward regions, inducting new technology and processes appropriate to the factor endowment situations in different parts of the country, encouraging utilization of hitherto commercially unutilized natural resources at dispersed centres, identifying and developing viable projects that can be implemented and operated by people of meager means and supporting them financially as well as with technical, marketing and managerial know-how are some of the dimensions subsuming the developmental obligations enjoined on these institutions. Extending financial assistance through term loans to qualifying entrepreneurs for their viable projects has been one of the primary functions of these development banks. Towards this direction, a development bank makes an independent and objective assessment of various aspects of an investment proposition for arriving at a financing decision.

The aspects to be considered while appraising a project are managerial, technical, financial, commercial, and economic. It is necessary to recognize the innate inter-relationship underlying various aspects of a project. Thus, the task of project appraisal requires the combined efforts of a team of persons from various disciplines such as engineers, economists, financial analysts etc. working in close coordination. Appraisal exercises are not only aimed at determining the viability of the project, but these are some
times also designed to reshape the project, so as to upgrade its viability. Also through project appraisal, though incidental is to initiate promoters of projects in modern management techniques and methods.

The depth and dimensions of a development bank’s evaluation exercise depends upon the homework already done by the promoters. Within this framework, the basic task of the appraising staff is to identify the critical areas of the project requiring in-depth consideration. In order to perform the task, the appraisal staff needs itself be armed with adequate information on various aspects of the project. Feed-back from the development banks own past portfolio, special market and industry studies relating to the industry and information retrieved in respect of the industry from within and outside the country are some of the important sources and methods available to the appraising staff for the said purpose.

The fundamental postulate on which the present study is premised is that the project appraisal is a crucial determinant of success or failure of an industrial unit to be undertaken for financial assistance by a development bank. A large number of observers of industrialization process in India and abroad have confirmed that projects fail because of lapses at the stage of planning and appraisal (Clifton and Fyffe 1977, Newalka 1979, Chitale 1981, Berry 1982, ICAI 1983, Krishna 1983, Naik 1983, Kuchhal 1984, Srivastava 1984, Roy and Dosage 1985, Singh 1986, Rajagopalan and Vyasulu 1990, Khanka 1993, Sell 1994, Bhat 1998 etc.).

1.1 STATEMENT OF THE PROBLEM

The state of Jammu and Kashmir is the northern most part of India. The state is vested with a good mineral base, substantial water resources and is famous world-over for its handicrafts, handloom products, tourism, horticulture produce and cottage industry. The valley (Kashmir region) has a dust free environment which is best suited for electronic industry as it has a tremendous potential for low volume, low weight and high value industrial units besides precision engineering industries. The Jammu region on the other hand can have all types of industrial units. In Ladakh region demand based and resource based industries can be set up. Although the state has made sustained efforts, based on its industrial potential to develop industry, evaluate its economic standard, it is yet to find a
place on the industrial map of the country. Owing to this fact whole of the state is declared as industrially backward state.

Traditionally industrial base of the J&K state lies in tourism and handicrafts. In tourism nature has been generous and almost every area of the state has tremendous tourist attraction. The state is also gifted with real craftsmanship in its populace. It has, however, been recognized that tourism and handicrafts alone do not and cannot provide sufficient ground for desired and sustained economic growth of the state. All round industrial development was essential to achieve this objective. Even in pre-independence era development of textiles involving silk and woolens got a tremendous fillip. In the earlier part of twentieth century the state also started development of economic infrastructures in a limited manner. Setting up of hydropower-generating units, silk reeling and weaving factories, sheep breeding farms, printing presses, public distribution systems are some of the ventures, which were taken up then.

Immediately after independence the government embarked upon an ambitious plan of industrial development of the state to meet people's aspiration of increased standard of living. In the initial years primarily, the focus remained on the traditional cottage industry. The State's exquisite handicrafts like paper machie, wood carving, shawls and carpets remained a major source of attraction of the state. Besides the stress was also on creation of capacities in the public sector. Public sector undertakings in different sectors of planned development including financial sector came up in the state. It was, however, soon realized that development of public sector undertakings or even efforts through cooperative movement couldn't form a ground for sustained industrial growth in the state. It was recognized that efforts of the state have necessarily to be supplemented by private sector to accomplish the desired objective. Strenuous efforts accordingly made in this regard started to attract private investment in the industries. Moving in this direction had, however, its own constraints major one arising from geographical placement of the state. The transport links with rest of the country as also within the state are not fully developed because of tedious terrain. Enough capital is not available within the state for tapping its natural resources. Industrial activity in this scenario was not an easy task and the state government came forward with a supporting hand with the help of industrial investment incentive packages adopted and updated from time to time.
It was only in 1961 that the government thought of promoting industry as an organized sector and to attract entrepreneurs offered a package of incentives, which was revised in 1972 and later in 1983. Besides commercial banks, various institutions like the J&K State Financial Corporation (1959), J&K State Industrial Development Corporation (1969), J&K Small Industries Development Corporation (1975), J&K Industrial and Technical Consultancy Organization etc. were established for accelerating industrial growth in the state by providing wide spectrum of services like financial assistance, infrastructure development, marketing cover, consultancy services etc. In its march towards industrialization, the state introduced District Industries Centre Scheme in 1978. This along with other institutions, extension of railhead to Jammu and grant of incentives lead to the growth of an industrial culture unleashing a hope of economic development all over the state.

The state effectively embarked upon an ambitious plan for industrial development by encouraging local entrepreneurs, attracting investment from outside the state besides creating and developing infrastructures from 1976-77 and the state witnessed an industrial boom during 1977-1987. The State government evolved an industrial policy in 1995 and laid emphasis on development of infrastructure and human resources. New Industrial Policy 1998-2003, which includes revised package of incentives, provides for a comprehensive strategy for rapid industrialization by encouraging investment, both foreign and domestic, in industrial sector to boost economic activity and generate employment. The number of registered SSI units shot-up from 6387 at March end 1977 to 26322 by March 1989, to 36821 by 1996 and to over 42000 ending March 2000. Loans advanced by banks and financial institutions also showed a phenomenal growth which reached to Rs.12.92 crores sanctioned during 1995-96 to Rs.15.07 crores during the year 1999-2000.

This phenomenal growth of industry, however, brought with it industrial sickness and other problems, which have gone out of proportion and assumed serious dimensions. As per the industrial census of small-scale industries conducted by Directorate of Industries and Commerce, J&K Govt. in 1998, 5146 units were found sick/closed, which accounted for 14.10 percent of the total units in the state. One of the major reasons for such a sad state of affairs had been found as an inadequate project planning. These units after
having established had engulfed into the problems like unavailability of raw materials and skilled labour, inadequate finances, insufficient demand, other marketing problems, etc.

The industrial units established with financial assistance of the development banks are expected to be stronger and successful as these institutions before arriving at a financing decision carry out a detailed appraisal of different aspects of the project. Any perceived shortcomings are set right at this stage itself. But the performance of the units assisted by two state-level development banks in the state viz; J&K State Industrial Development Corporation Ltd. (J&K SIDCO) and J&K State Financial Corporation (J&K SFC) has not been satisfactory. Out of 97 units assisted by J&K SIDCO upto March 31, 2000, the institution failed to effect recoveries of dues (principal and interest) in respect of 86 units. Out of these defaulting units, 29 are closed and 30 are either sick or partially functioning. J&K SFC has provided financial assistance to 9002 industrial units (including artisans) so far, and out of which 1390 units are completely defaulted against principal and interest. The major reasons as perceived are that the vital area of project planning, financial, commercial, technical and managerial resourcefulness of promoters had not received proper attention while evaluating the project for financing by these institutions and with the result the units have failed to run adequately and effectively.

While a number of experiments have been made to strengthen the project appraisal practices by the financial institutions all over India, the process in development banks of J&K State is weak and does not accomplish the expected results. Inadequate expertise of officers of development banks, insufficient data base for undertaking more thorough demand projections, poor estimation of project costs and testing of assumptions underlying profitability estimates, short term rather than a continuous vigil to focus on supervision and end use activities, ill identification and lack of appropriateness of plant and machinery, lesser selectivity in accepting projects with changing business and resource environment etc. lead to a high incidence of project cost over-runs and poor estimations in appraisal work done by the development banks. This results in wrong selection of the projects for the financial assistance. Some projects after having availed term loan assistance never reach the stage of commencement of commercial production and some others become sick units later. Thus, these units which are expected to promote industrial culture in addition to repay the loans along with the interest, approach the development bank for more funds to
meet the over-runs/rehabilitation. This has serious implications for these institutions to grow and to cater to the needs of new entrepreneurs coming to the scene of industrialization. It is, therefore, imperative to devise a comprehensive mechanism for wider and extensive analysis of project proposals before they are approved for financial assistance by the development banks in the State. The present study is an attempt in this direction.

1.2 OBJECTIVES

The study primarily has the following objectives:

i. To study the present procedure followed in processing of the project proposals for term loan assistance by the development banks of J&K State.

ii. To examine the expertise base of development banks for assessing various aspects of industrial projects.

iii. To ascertain the bases adopted in determining the feasibility of projects in terms of technical, commercial, economical and managerial aspects.

iv. To study the techniques employed by appraisal officers and their appropriateness for ascertaining the financial viability of industrial projects.

v. To critically analyze the financial viability of the projects on sensitivity framework and assess their financial implications.

vi. To highlight the strengths and weaknesses in project appraisal systems and processes prevailing in development banks.

vii. To suggest some suitable measures for implementation of proper practices of project appraisal on the basis of study results.

1.3 HYPOTHESIS

In consonance with the aforesaid objectives, the following hypotheses were formulated for verification and confirmation:

i. Project appraisal work by development banks is not based on adequate data.
ii. Prescribed norms are not followed in evaluation of technical, commercial, economic and managerial aspects of a project.

iii. Adequate and appropriate financial techniques are not used for determining the financial viability of a project.

1.4 SCOPE OF THE STUDY

The term project can mean industrial projects, agricultural projects, health projects or service-oriented projects. For the purpose of this study, the term project has been defined to mean only those which are industrial projects and are mainly concerned with manufacturing activity.

Projects may be financed in various ways. These may be financed by raising share capital, seed capital assistance, term loans, working capital assistance etc. The focus of this study is on projects assisted by development banks by way of term loans.

Different authorities may do project appraisal. It could be done by development banks for the purpose of granting assistance, commercial banks for short-term and long term loans, investors and shareholders to assess the attractiveness or otherwise of certain returns, by govt. agencies for fulfillment of the legal requirements and policy decisions, by auditors - internal, statutory or govt. to fulfill the legal requirements, environmentalists to assess the impact of the project on society or by the company’s own management team to assess its performance. For this study the appraising authority has been defined as the development bank, which, takes up the appraisal while granting assistance.

Project appraisal may be done at different points of time in the life span of a project. It could be done at the inception of the project, at the stage of rehabilitation in case of sickness, at the stage of expansion, modernization or diversification. In this study the timing of appraisal is taken as a) new projects and b) projects which go for expansion and diversification.

In-depth study, however, was necessarily restricted to the financial aspects, the other criteria being broadly reviewed. For example, it was not possible to review intensively the marketing or technical data appraisal conducted by the institutions except to ascertain the procedure adopted and the broad aspects considered in reviewing the data.
Moreover, the scope of the study is restricted to two state-level development banks viz; J&K SIDCO and J&K SFC established in the State of Jammu and Kashmir for development and promotion of industrial growth. In this study, the analysis of the appraisal process selected from these development banks is referred to as project study (PS).

1.5 RESEARCH DESIGN

In consonance with the aforesaid objectives, the following research design was pursued for the analytical study of the problem:

1.5.1 Sample Design

Two apex development banks operating in Jammu and Kashmir viz; J&K SIDCO and J&K SFC have been selected for in-depth analysis of policies and practices undertaken for evaluation of a project.

In-depth review was conducted of specific project proposals for an empirical assessment of the procedures followed and the bases adopted. Out of total project proposals received by these development banks during 1990-2000, fourteen appraisal processes of industrial projects entertained for financing were critically examined and evaluated. Due to wide spectrum and network of activities of J&K SFC and its role in the development of small-scale industries, ten projects were purposively selected from this organization. Four projects were purposively selected for in-depth study from J&K SIDCO, which is mostly catering to the financial needs of medium and large-scale industries in the state. While selecting the projects for the in-depth study, care was taken to cover the projects approved at different time intervals, covering different production lines and representing different forms of business. Project appraisal parameters were also kept in mind while identifying the sample projects.

1.5.2 Data Source

The present study is based on secondary data. Various appraisal reports, project files, detailed project reports of industrial projects for term loan financing, annual reports, status reports and the development banks prospectus were studied to give a fair picture of their working, appraisal work and the considerations for financing an industrial unit. Data for the selected projects have been collected from the application forms, project reports,
appraisal reports, the available documents and files pertaining to these projects. To ensure dependable conclusions the data was used only after thorough scrutiny.

Personal discussions and interviews were conducted with the officials/executives of these development banks in order to supplement the data with certain unwritten facts. Discussions were also held with the promoters approaching for assistance in order to know their perceptions with regard to project appraisal process carried out by these development banks.

The information for the study was also collected from various books, journals, circulars, periodicals, reports/publications of various institutions like Industrial Development Bank of India, Small Industries Development Bank of India, Reserve Bank of India etc.

The period of the working and the practices followed in project appraisal processes by these development banks span over ten years from 1990-91 to 1999-2000.

1.5.3 Tools of Analysis

The collected data has been tabulated, analyzed and interpreted with the help of various accounting, financial and statistical tools. Various financial techniques including discounted cash flow techniques have been used for determining the financial viability of the projects recommended for term loan assistance by these development banks.

In view of the broad guidelines, procedures and practices in the project appraisal process followed by the two development banks under study, no comparative study was felt necessary.

1.6 ORGANIZATION OF THE STUDY

The study is organized in six broad chapters with the following brief description:

The present chapter is introductory in nature. It deals with the statement of the problem, scope, objectives, research design, means of collecting data and chapter scheme of the study.

A complete conceptual framework of the various processes undertaken for project appraisal exercise has been dealt in chapter II. With a view to evolve an appropriate
methodology for the study and determine the need for the same, related literature on the subject has been reviewed. This chapter surveys the criteria for investment decisions by the financial institutions and the evolution of such analysis in India.

Chapter III presents the functional assessment and the formal procedure for processing of loan applications by the development banks under study. It takes an overview of the objectives, activities, quantum of financial assistance provided, recovery position etc. of these institutions. It also presents the procedure for applying for financial assistance by promoters, information sources, various decision-making stages and the processing time taken by these institutions in carrying out the appraisal work. The loan applications received, sanctioned, closed/withdrawn etc. in the last ten years are also dealt with in this chapter.

A critical analysis of the sample appraisal studies of the industrial projects carried out by these development banks is presented in chapter IV. The procedures followed and the bases adopted in ascertaining the viability of various aspects of these industrial projects viz; technical, commercial, managerial, economic and financial have been reviewed. The elaborative version of ascertained financial viability of these projects has been reviewed.

Chapter V undertakes the financial viability of the projects as per the prescribed procedures and norms. It focuses to assess the viability of these projects in terms of the operations throughout their economic life and in terms of repayments and debt service towards the development banks. Financial projections and financial analysis of the projects have been carried out under a sensitivity framework. It also identifies the areas for upgrading the financial viability of the projects.

Chapter VI lists the major findings and conclusions that emerge from this study. Based on study results, some suggestive measures have been provided for improving the project appraisal practices in the development banks.