**TRAINING IN FINANCIAL AND BUSINESS MANAGEMENT FOR ROAD CONTRACTORS**

**MODULE FIVE: SESSION TWO PARTICIPANTS’ NOTES**

**FINANCING OPTIONS AVAILABLE TO ROAD CONTRACTORS**

**1.0 Overview of SME contractor finance:**

Access to finance is one of the major constraints for the market entry and growth of small and medium construction companies tendering for public work contracts in developing countries. The financial mechanisms include bridge finance, credit guarantees, pre-financing of equipment by public work programmes, Term Loans, conditional sale contract and above all leasing. Besides these there are other mechanisms which can be used to finance working capital requirements and accounts receivables and among these include: operating line of credit, accounts receivable financing or factoring, purchase order financing and Business Improvement Loans (BIL).

Small contractors working on labour based public works programmes often have limited access to formal financial services. Operating in countries where interest rate ceilings and collateral requirements generate a gap between small businesses and banks, contractors are bound to rely on informal and ad-hoc types of financial services. The most prominent constraint contractors face in this situation is the difficulty to find appropriate financing for working capital and for the acquisition of construction equipment. Less obvious but associated problems relate to the absence of savings, money transfer and insurance facilities.

The difficulties that contractors have in attracting finance can strongly affect the outcome of the public works programmes. They lead to a variety of sub-optimal situations where construction companies delay operations, work with the wrong type of equipment and pull out because of sudden illiquidity problems. Faced with these realities, contracting agencies are often obliged to facilitate contractors’ access to financial services. They either pre-finance operations, take some of the financial risk by guaranteeing bank loans or set up leasing or hire-purchase arrangements. The success of these interventions largely depends on the nature of the public works programme, on the specifics of the local financial market and on the degree to which the design of the arrangements is adapted to the local circumstances.

**1.1 Equipment finance for small contractors:**

Small contractors tendering for labour based construction contracts mostly use their own funds and family savings to invest in equipment. Using predominantly light equipment like trucks and tractors the contractors are flexible as to the type of work they undertake. A large share of the financial resources used for procurement comes from non-construction activities, such as transport and trade. (*Norconsult A. S. Consulting Engineers, Equipment Leasing Management Services: Uganda Transport Rehabilitation Project- Feeder Roads Component. Quarterly Report January 2006.*)

In situations where the entrepreneur has insufficient funds to purchase new equipment, he/she will look for second-hand trucks and machines on the local market.

Suppliers’ credit seems to be the most common source of external financing of equipment amongst small contractors. Competition on the suppliers market defines whether equipment vendors sell on credit and what they charge in terms of down payment and interest. In many developing countries Uganda in particular, however, equipment firms only provide suppliers’ credit to larger firms operating in urban areas. The facility is restricted to trustworthy clients that have an established relationship with the firm.

Some of the more general equipment used in infrastructure construction, like trucks and tractors, can often be rented on the local market. The facilities and conditions to rent equipment differ from country to country and from region to region. In many rural areas the demand for rentals exceeds supply, making it difficult for the contracting firms to rent appropriate and well-maintained equipment.

**1.2 Guiding principles to support contractor finance:**

Under-equipment of contractors can pose serious threats to the quality of the work performed and to the objectives of the public works programme. Therefore in many labour based public works programmes the contracting agency facilitates the procurement of equipment by the contractors. The contracting agency either pre- finances equipment, stands as a guarantor for bank loans or sets up a leasing scheme. The decision to opt for any of these mechanisms should be based on the following three principles;

1. ***Market rates:***

First of all the contractors should be faced as much as possible with a ‘real- life situation’.

One of the common objectives of labour-based programmes is to build the capacity of contractors and to help them turn their business into viable enterprises. This means the contractors should be charged market interest rates, they should be required to arrange their own affairs and they should establish their own contacts with financial institutions. Any diversion from the situation the contractors will be faced with after the completion of the programme will diminish their chances to sustain their business successfully. *A proven credit history and repayment record with a professional financial institution is a valuable asset for any contractor wanting to expand business.*

1. ***Reimbursement capacity:***

A second principle is that the investment in equipment by the contractor should be justifiable from the income expected. In other words, contractors involved in the programme need to make a projection of their reimbursement capacity. Such a projection is based on the amount of income the contractors will be able to realize through future work contracts, taking into account that the companies should maintain sufficient working capital to run the operations.

1. ***Simplicity:***

The time and money spent by the programme to set up an adequate financial scheme for the contractors has to correspond to the volume of works. Negotiations with possible financial partner institutions can be slow and can cause enormous delays in the actual works to be executed. Construction of financial schemes or arrangements tends to require more creativity, but is also more complicated and expensive during negotiations that involve donor agencies, contracting agencies and financial institutions.

**1.3 What are the options for Financing?**

The possibilities for financing for small and medium contractors include:

* ***Leasing or hire purchase schemes***
* ***Pre-payment of equipment by the project***
* ***Equipment pools***
* ***Bridge financing***
* ***Guarantees on work, on payments or on credit***

In many donor-funded public work programmes the necessary equipment is initially procured and financed by the donor. The equipment is then registered as property of the agency that implements the programme, which could be either a Ministry of Public Works or Transport. When the equipment is registered in the name of a ministry, the options to set up a financing scheme to equip the contractors are limited. Firstly a government agency will legally not be allowed to sell the equipment to a financial intermediary such as a leasing agency. Secondly, when the government plays a double role as both contracting agency and owner of the equipment, conflicts or interest can arise. Whether the best option is a leasing arrangement, a pre-payment of equipment or a guarantee for bank finance will therefore depend on ownership issues and on whether the equipment has already been procured by the programme.

 **Leasing**

**What is leasing?**

One of the possibilities for contractors to finance their equipment is to look for a leasing arrangement. Leasing is a common way for small and medium sized enterprises around the world to finance vehicles, machinery and equipment. Over the last decade the leasing industry in developing countries has seen a spectacular growth, with even micro- finance institutions becoming interested in the concept.

Financial leasing is a contractual arrangement that allows one party (the lessee) to use an asset owned by the leasing company (the lessor) in exchange for specified periodic payments. During the lease period legal ownership of the asset is retained by the lessor.

Most leasing contracts will include the option for the lessee to purchase the asset at the end of the lease term for a nominal price.

The great advantage of lease finance for contractors is the absence of collateral requirements. The equipment itself will serve as security for the transaction since the ownership of the asset is retained by the leasing company. In case the contractor is unable to make the periodic payments the leasing company can simply repossess the asset. A leasing arrangement can be concluded quicker and simpler than a bank loan. Rather than looking into the credit history and the asset structure of the client, leasing companies will focus on the clients’ ability to generate sufficient cash through the investment financed in the leasing arrangement.

The down payment in a lease arrangement is often low and the percentage of capital cost of the equipment financed high. Whereas banks often require clients to finance up to 40% of the investment from their own funds, the up- front payment in a typical lease arrangement accounts for only 10% of the total cost. This enables contractors to keep their resources as working capital for the payment of salaries and construction materials. Another advantage of leasing over hiring of equipment is the incentive that contractors have to properly maintain the equipment.

**Types of leasing**

*Four different types of leasing can be distinguished1*:

A. **Finance lease or Capital lease** is an alternative to bank loan financing for equipment purchases. The lessor buys the equipment chosen by the client, who then uses it for a significant period of its useful life. Financial leases are also called full-payout leases because payments during the lease term amortize the lessors’ total purchase costs (residual value is typically between 0% - 5% of original acquisition price), cover his interest costs and provide him profit. The lessee carries the risk of obsolescence, the costs of maintaining the asset and insurance. The lessee typically has the right to purchase the asset at the end of the lease contract for a nominal fee.

B. **Hire-purchase** is a hybrid instrument also providing an alternative to bank financing for the purchase of equipment. The instrument is typically used for retail or individual financing of motorcycles, sewing machines, refrigerators, and other small items. The lessee pays a higher down payment (sometimes up to 30% of the purchase price) and, with each lease payment an increasingly higher percentage of ownership is transferred to the lessee, thus building up equity. Ownership transfer is automatic once all required payments are made. Compared to a financial lease, this arrangement is judicially less secure for the lessor because the lessee is part owner of the asset. On the other hand, lessees have a sufficiently large stake in the equipment being acquired to avoid the risk of losing that stake through default.

C. **An** **operating lease** is not a means to finance equipment purchase. The lessee signs a contract with a leasing company for short-term use of a piece of equipment the leasing company has on hand, e.g. car rentals. The lessor recovers the capital cost of the equipment from multiple, serial rentals and the final sale of the asset. Maintenance costs and risks of obsolescence are borne by the leasing company.

D. **A** **sale and lease-back** arrangement is like a financial lease, with the difference that the client initially owns the piece of equipment. The client sells the equipment to the lessor, in order to acquire funds for working capital. At the same time the client signs a lease contract to lease back the equipment through regular lease payments.

**The lease arrangement**

In a standard financial lease the lessee – in this case the small contractor - selects the equipment and negotiates the main purchase terms with the supplier. In case the lessor selects the equipment a fee can be charged for this service. While the asset itself serves as collateral under a lease arrangement, some leasing companies will ask for additional collateral in the form of marketable securities, trade receivables or third party guarantees. Most lease contracts will contain a clause requiring the lessee to provide the lessor with certified financial statements during the period of the lease.

Leasing rates are often slightly higher than bank interest rates. On top of the leasing rates the lessor will charge the client a nominal fee for the administrative costs related to the lease arrangement. The lessee is usually responsible for the costs of maintenance, servicing and repairs of the equipment. In most cases the lessee is obliged to insure the equipment.

Leasing arrangements still remain attractive as the up-front down payments are low and as contracts can be structured to match the cash flow generation of the contractors business.

**Tax incentives**

Tax incentives lie at the basis of the rapid expansion of the leasing sector in industrialized countries. In order to facilitate entrepreneurs’ access to finance for productive equipment, many countries have embraced a tax system that is conducive for both lessor and lessee. The lessor, treated as the owner of the equipment, registers the full lease payment (principal and interest) as income but takes the depreciation of the asset, usually on an accelerated schedule. The lessee claims the lease payment as deduction from taxable income. Since the lease term is usually shorter than the economic life of the equipment, the lessee in fact **“depreciates”** the equipment more rapidly than it would in case of purchase of the equipment. Since both parties accelerate depreciation of the asset, total tax payments are decreased, to the benefit of the leasing industry.

While similar tax incentives might exist in developing countries, they are not the main reason for the expansion of leasing companies in Africa and Asia. The use of accelerated depreciation to avoid paying income tax are less relevant to small and medium sized enterprises. Simpler security arrangements and low down payments are more likely explanations for the growing importance of leasing to SMEs in developing countries. However given this position, SMEs need to change their attitude and start utilizing the tax advantages associated with lease financing e,g interest payable on lease is an allowable deduction for tax purposes in Uganda (Income Tax Act 2001 as amended), and in Finance lease the lessee benefits from capital deductions which eventually reduces his/her tax liability.

**Experiences involving leasing companies in contractor finance**

Although developing countries are driving most of the growth of the leasing industry today, the operations of leasing companies are still limited to urban areas. Leasing contracts between town-based leasing companies and small contractors operating in the rural areas are less common. ***Limiting factors to urban-rural leasing are the following:***

* The cost of monitoring the status of the leased equipment and the financial performance of the enterprise is high when it involves travelling to the country side;
* Contractors who keep the equipment in rural areas far from suppliers shops and workshops have more difficulty maintaining it;
* The cost of repossession of the equipment in case of non-payment is high when the equipment is kept far from the lessor’s premises.

**Options to explore:**

* Having Local agents in rural areas who could do the monitoring and charge a small premium to cover the extra cost
* Asking for additional security to cover the rural risk but the rural based contractors are likely not to have the required security.

***The reluctance of Ugandan financial institutions to lease equipment to contractors working in the rural areas of Uganda:***

**Uganda: Selection of financial institution**

The Uganda Transport Rehabilitation Project invited six different financial institutions to lease equipment to contractors. All development banks and leasing companies approached were initially reluctant for a set of obvious reasons:

* The financial institutions have no branch offices in the rural areas and are therefore unable to monitor the performance of the contracting companies;
* The selection of contractors is done by the project on the basis of a different set of criteria than those that would be used by the financial institution to screen their clients;
* The contractors are first-time borrowers that lack expertise in financial management and bookkeeping.
* Maintenance of the equipment becomes an issue when the project site is far from dealers and workshops.

The involvement of the Ministry of Transport in most projects as implementing partner discourages the financial institutions as delays in payments to the contractors are foreseen.

***(Source:*** *Republic of Uganda, Ministry of Local Government: Report on contractors’ equipment leasing Options, 1995), a study by Linda Kwaku osei Bonsu, March 2006)*

**Pre-payment of equipment by the project**

**Deduction of equipment costs from the work payments**

In many labour-based public work programmes the equipment needed for the work is purchased and pre-financed by the project. From the point of view of preparing contractors to sustain operations in real-life situations, the option of pre-financing equipment is second best.

The contractors are not faced with the procedures and realities of financial institutions and do not build up track records with the bank. However for the sake of simplicity pre-financing equipment seems a viable option for small public work programmes.

In most schemes the Ministry of Transport or Public Works becomes the de facto owner of the equipment. At the moment the equipment is handed over to the contractors, a loan agreement is signed between ministry and the contractor. The agreement allows the contracting agencies to deduct loan repayments from the work payments. In case of exclusion of a contractor from the work for whatever reason, the ministry will attempt to repossess the equipment and hand it over to new contractors entering the scheme.

Pre-payment arrangements and loan contracts with the Ministry of Transport or Public Works can run into problems as soon as the ministry becomes unable to either provide work or to pay the contractors in time. More complications arise when delays in payment are due to bad or slow performance of the contractors or to circumstances beyond the control of both the contracting agencies and the contractors. A loan contract will have to stipulate clearly in which circumstances the contractors are allowed to suspend their repayment schedule.

When contractual payments are made in local currency, the loan agreement would normally have to be stated in local currency as well. Repayments, however, can rapidly loose their value, certainly if instalments are suspended due to factors mentioned above. In some public work programmes, funds accumulated are used for either new construction or maintenance of constructed works.

**Administration of the scheme by a financial institution**

In some cases the project or contracting agency opts to subcontract a financial institution for the administration of the credit scheme. The involvement of the financial institution would ensure efficient financial management and administration of the credit scheme. The scheme has the advantage of bringing the contractors in contact with a financial institution that could eventually render them financial services after the completion of the project. The cost of hiring the services of a financial institution though can be high and can easily off- set the advantages in smaller schemes.

The credit arrangement could resemble a leasing arrangement where ownership of the equipment goes to the contractor only after the last payment has been made. However, since the financial institution is not the de facto owner of the equipment and therefore runs no real financial risk, monitoring from the side of the financial institution will not be as thorough as it would be in a real lease arrangement. It is doubtful whether the financial institution would enter complicated and expensive legal procedures after the default of a client as it would in a straightforward debtor/creditor situation.

 **Equipment pools**

In some labour-based public works programmes ownership of the equipment is retained by a local government agency that sets up an equipment pool. The establishment of an equipment pool at a government agency has many disadvantages compared to other options described earlier:

* The equipment is usually not properly maintained. Local government agencies in developing countries have enough problems maintaining their own car park, let alone an equipment pool used by contractors.
* Contractors will understand that the equipment they need for the execution of the work will always be available at the equipment pool in a good state at the moment they need it .However, this may not always be the case. At the time of execution of work the equipment may not be in good condition hence blaming the contracting agency for the delays in the execution of work. The rental rates set by government equipment pools are often set too low to cover the costs of maintenance and amortization2. Rates that don’t reflect market hire rates do not prepare contractors to compete in real market situations. Contractors will tender using the official governments hire rates for equipment, even though they realize that defaults may occur. When some of the equipment is not available in the equipment pool, contractors will be unwilling to hire the equipment from the private sector.

**Bridge financing and guarantees**

**Bridge financing:**

In bridge financing large loans for short terms are given out, using a secured future income as guarantee. Bridge financing is often used in the agricultural sector to bridge the period from investment in the crop until harvest. Contractors on labour-based public work programmes can use the construction contract as guarantee to obtain bridge financing.

Experience shows, however, that banks are disinclined to provide bridge finance to contractors when the contracting agency is a public entity. (Bentall P., Beusch A., de Veen J., Employment-Intensive Infrastructure Programmes: Capacity Building for

Contracting in the Construction Sector, International Labour Organisation, 2009)

Work contracts as such do not guarantee work payment, which ultimately depends on the performance of the contractor and the administrative procedures of the contracting agencies.

In general, commercial banks in developing countries are reluctant to lend to small contractors operating in rural areas for a set of reasons:

* ***The contractors are often first-time borrowers without any track records at the bank;***
* ***They are unable to fulfil the collateral requirements of the bank;***
* ***They cannot present their last years’ financial statements to the bank;***
* ***They are unable to finance 20-50 % of the investment from their own resources as required by the bank.***

*Banks will generally require collateral or third party guarantees as compensation for the perceived higher risk involved in lending to small contractors*. In these situations a contracting agency can facilitate contractor’s access to bank finance by providing them with guarantees. For a contracting agency there are three different possible ways to stand guarantee for a contractor: guaranteeing work, guaranteeing work payments or guaranteeing loans.

**Guaranteeing work:**

The simplest solution from the perspective of the contracting agency is to prepare a letter guaranteeing the contractor a certain amount of work. By showing this letter to the bank the contractor will provide the bank with evidence of liquidity during the period that the work is guaranteed. Such a letter could be combined with other third party guarantees the contractors could find on their own behalf.

In most instances a document guaranteeing work by itself will not be sufficient for contractors to access credit for the procurement of equipment. A contracting agency can only guarantee work for a certain period, not for the duration of the whole programme.

Guaranteeing work to facilitate a lease arrangement makes more sense than guaranteeing work in order for the contractor to obtain a bank loan. The difference is that in leasing both equipment and work contracts can be transferred relatively easy to another contractor that has been trained in labour-based technology.

**Guaranteeing work payments**

In cases where banks consider letters of guarantee as described above as insufficient, the contracting agency could agree to make payments to the contractors through the bank, allowing the bank to withhold parts of the payments in case of bad loan repayment by the contractor. In many countries, however, the bank is legally not allowed to withhold such payments and in all instances the consent of the contractor has to be sought. Any contract, signed by the three parties, would have to state clearly the conditions under which the bank can withhold payments, for example:

* ***Arrears and non-payment reach at least 90 days;***
* ***The defaulting contractor has been appropriately warned.***

The contract would have to state clearly which sums the bank would be allowed to withhold at what moments:

* ***Missed instalments only;***
* ***Penalty interest;***
* ***Outstanding principal;***
* ***Legal expenses***.

Care should be taken in using this method even in countries where the legal framework supports it. The advantage of the method is that the contractors are backed in their efforts to establish contacts with a formal financial institution at no additional costs. The risk is that when payments are withheld, contractors are not able to pay the wages to the workers

Another factor to take into account when pursuing a guarantee arrangement is that banks do not always regard government agencies as the most reliable financial partners. A bank could ask for additional certainty that payments will be in time such as the existence of earmarked government funds or dedicated donor- fund accounts.

**Guaranteeing loans:**

A third possible way to facilitate contractors’ access to bank finance is to guarantee the loans that contractors take to finance their equipment. In practice this means that the programme would set up a guarantee fund on the basis of which it can provide the contractors with letters of guarantee. In a letter of guarantee the programme agrees to share the loan risk with the bank. In case the contractor fails to repay the loan, the programme pays part of the outstanding debt instead.

***In a guarantee arrangement the loan risk has to be shared between the bank, the contractor and the guarantee fund.*** In situations where the guarantee fund of the programme covers more than 80% of the risk, the bank is likely to become lax in monitoring and loan follow up. At the other hand, banks will usually not agree on a coverage of less than **50%.** Good risk sharing arrangements are in between ***60% and 80%.***

A letter of guarantee is a legal document that states exactly what sums the bank can claim from the guarantee fund when the contractor defaults on the loan, for example:

* The guarantee fund will be liable for a percentage of outstanding loan capital and contractual interest.
* The guarantee fund will not be liable for penalty interest and legal expenses.

The bank can call in the claim after 90 days of arrears, after a warning letter has been, etc.

**Term Loans**

**Term Loans are a form of business credit.** The fact that term loans are credits extended to business concerns serves to differentiate them from many other types of loans, also having terms of more than one year, that are made by commercial banks, insurance companies and other financial institutions. The salient factor is that the term lender usually appraises the probabilities of financial success of a business enterprise in judging the likelihood of repayment of the loan at maturity. ***Term Loans Involve a Direct Relation Between Borrower and Lender.***

The term loan is unique in being a medium-term credit, usually accompanied by a formal loan agreement between borrower and lender, but retaining that direct and intimate connection between business concern and financing agency that has always been associated with the business loan activities of commercial banks.

***Term Loans Are Credits Extended for More Than One Year***

**CONDITIONAL SALES CONTRACT**

A lease agreement banks can offer to business customers that wish to finance purchases of new equipment. The business is able to take possession of the property as soon as the agreement is in force, but does not own the property until it has paid for it, which is usually done in instalments. If the business defaults on its payments, the bank will take possession of the item.

* A conditional sale is a type of agreement to sell. It is commonly known as "buying on the instalment plan". It is a contract whereby a seller retains title to goods sold and delivered to a purchaser until full payment has been made.
* A conditional buyer has the right to possession of the goods/chattel so long as the terms of the Conditional Sale Agreement are met.
* A conditional buyer obtains ownership in the goods/chattel as soon as the final payment to the seller is made.
* A conditional buyer is usually required to give a promissory note for the total price due under the contract.

Note: A capital lease has similar characteristics to a term loan and a conditional sales contract.

**Advantages**
* Constitutes an alternate source of financing for the conditional buyer and thus leave other credit sources i.e. bank lines of credit to finance the business.
* Does not require a large up-front capital expenditure.
* Conditional buyer is usually able to negotiate repayment terms that are more favourable than might otherwise be available in a traditional buyer/seller transaction.
* Conditional buyer does not record the goods/chattel on the balance sheet as an asset since title has not changed hands. This may have favourable consequences from a financial reporting perspective.

**Disadvantages**
* Conditional seller is a creditor and may sue for any unpaid balance owing under the contract.
* Conditional buyer is responsible for damage to the goods/chattel regardless of whose fault it is.
* Conditional buyer may be restricted in how it can deal with the goods/chattel prior to repayment of the contract.
* Conditional seller may discount the promissory note with a finance company

**WORKING CAPITAL FINANCING AND ACCOUNTS RECEIVABLE**

1. **ACCOUNTS RECEIVABLE FINANCING/FACTORING**

A type of financing arrangement in which a company uses its receivables - which is money owed by customers - as collateral in a financing agreement. The company receives an amount that is equal to a reduced value of the receivables pledged. E.g in road construction business this could be certified work (accounts receivable).

Receivable financing, also known as factoring is a method used by businesses to convert sales on credit terms for immediate cash flow. Financing accounts receivable has become the preferred financial tool in obtaining flexible working capital for businesses of all sizes. The receivable credit line is determined by the financial strength of the customer (Buyer), not the client (The seller of the receivables).

1. OPERATING LINE OF CREDIT

Every business needs the cash to operate and fill the gap between **accounts** payable and receivable. An operating line of credit acts as a cushion to help you manage seasonal cash shortfalls and make hiring or purchase decisions now that will pay off in the future. It is intended to **cover the short term capital needs.** Secured against accounts receivable and inventory, operating line gives you access to the cash you need day to day so that your business stays steady and more agile. The line of credit can be revolving or non revolving.

1. PURCHASE ORDER FINANCING

The assignment of purchase orders by a business to a third party who accepts responsibility for billing and collecting from buyers of the company’s products. It is a form of expensive financing used to purchase materials required to produce products needed to fulfill a purchase order already received from a buyer. E.g in road construction business the required material would be cement or lime.

4. **BUSINESS IMPROVEMENT LOAN**

These are Short term business loan with regular payments targeting micro business enterprises for financing working capital. The loan is targeted at the borrowers involved in commercial activities .

Group activities

1. Describe the various ways of financing equipment for SMEs in road construction
2. Analyze credit policy & procedures for commercial/corporate loans **(Centenary bank).**
3. State the key components one would expect to find in a typical loan assessment system.
4. Identify the advantages and disadvantages of using contractor finance in road construction.
5. Identify the key challenges in raising contractor finance and suggest how they can be addressed.