Assessing Financial Viability of the Project

Certain tools help us assess the financial viability of any project where investment is contemplated. We will discuss some tools in brief.

Tools that determine the adequacy of the surplus:

**RETURN ON INVESTMENT (ROI)**

**What is Return?**

As we know, a project collects funds from two sources for long-term investment. The amount collected is used to create assets and operation, which generates surplus for the enterprise. Surplus is required to be distributed to the contributors of the funds. Interest is the compensation given to contributors of borrowed capital, and net profit and depreciation are given to contributors of own capital. Why should one add depreciation here? Though depreciation reduces profit, it is a non-cash provision made to recover the original investment. Thus, the cash profit of the enterprise is increased to the extent of depreciation.

The total surplus generated by the project over its entire life has to be averaged to find out yearly return. This yearly return, when calculated on the total investment needed for the project, tells us about the Return on Investment. Simply speaking, this ratio tells us the surplus-generating capacity of the investment.

One must know how much RoI a viable project must generate. This is an important question that needs to be answered to know the financial viability. The simple rule to assess the viability is that the RoI must be greater than the cost of investment.
First look at the investment cost. Investment comprises two major components:

i. Borrowed Capital (Normally taken as loans from banks and financial institutions)

ii. Own Capital (Normally contributed by entrepreneurs)

It is simple to calculate the cost of borrowed capital. Any borrower is required to commit the fixed service charge, i.e. interest at the time of sanctioning loan. Thus, the interest becomes the cost of borrowed capital. Interest is tax-allowed expense and, therefore, its effective weight is reduced by the actual rate of tax paid by the borrower. The entrepreneurs may have more than one investment alternative and under such conditions, the opportunity cost becomes the cost of entrepreneur’s capital.

**Acceptance Rule**

For the investment to be financially viable, the RoI should be greater than the cost of investment.

**DEBT SERVICE COVERAGE RATIO (DSCR)**

Running an enterprise with financial support from banks/financial institutions, requires their loans to be repaid with interest. Therefore, an entrepreneur must generate surplus, adequate to meet repayment obligations. The DSCR is a tool used to determine this. Its formula is:

\[
\text{DSCR} = \frac{\text{Net profit} + \text{Interest (on long term loans)} + \text{Depreciation}}{\text{Interest (on long term loans)} + \text{Principal Loan}}
\]

**Acceptance Rule**

A project is considered financially viable if the cumulative DSCR during repayment period is at least 2:1

**BREAK-EVEN POINT (BEP)**

This is another important tool. The break-even point is the level of activity where the total contribution is equal to the total fixed cost. Contribution is the excess of sales over variable cost, i.e.;
Contribution is a type of surplus that the business generates after paying fully the variable cost from the sales revenue.

The break-even point is the point of activity where all costs (variable as well as fixed) are recovered from the sales values. The business, therefore, does not make profit or loss. For any activity below break-even, the business will incur loss, while it makes profit when activity is above it. So, when the business fully pays for the total fixed cost from contribution, the unit can be said to have achieved the BEP. When contribution fully pays for fixed cost, the business is said to have achieved break-even. Several formulae have been evolved to calculate break-even:

1. \[
\frac{\text{Total Fixed Cost}}{\text{(In quantum of activity)} \times \text{Contribution per unit of activity}}
\]

2. \[
\frac{\text{Total Fixed Cost}}{\text{(In sales value)} \times \text{Contribution per unit of activity} \times \text{Selling Price per unit}}
\]

**Acceptance Rule**

The BEP indicates the risk involved in a project. Normally, enterprises achieving break-even sales level at a higher capacity utilisation, are considered to be more risky, while those achieving it at a lower level of capacity utilisation are safer. The thumb rule is lowering the break-even betters the proposition.

**DEBT-EQUITY RATIO**

This ratio indicates the extent to which the promoter’s funds are leveraged to procure loans. The formula of DER is:

\[
\frac{\text{Total long-term debt}}{\text{Total promoter’s funds (includes subsidy)}}
\]
A higher debt equity ratio indicates more risk due to a higher fixed cost of interest. The BEP of such enterprises will go up.

**Acceptance Rule**

It would be desirable to maintain the DER at a judicious level, say, varying between 2:1 and 3:1 for small and micro enterprises.