

USDA Feasibility Standards and Project Risk

**USDA Rural Development Team – California
Community Programs Training**

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Strategic Feasibility Study Defined

- Part of a larger study.
- Measures capability and readiness for strategic capital project.
- Analyzes three years historic data.
- Forecasts pro-formas five years forward.
- Answers question: is project feasible?
- Results in decision to proceed, continue study and preparation, or to abort.

A Better Question

- Shouldn't we ask:
 - ✓ “What are the chances we won't get our money back?”
- Recognize distinction between accounting feasibility and economic feasibility.
- More emphasis on economics and risk in strategic and feasibility studies.
- Use of decision analysis.
- Fewer unpleasant surprises.

What Does This Mean for USDA?

- Important investor in rural debt markets.
 - ✓ rural debt presents risks of its own
 - ✓ rural infrastructure depends on USDA
- USDA understands these risks better than most banks and accountants.
- As guarantor, cannot rely on feasibility standards set by banks.
 - ✓ introduces moral hazard
 - ✓ poses conflict of interest for banks
- As lender, develop economic feasibility standards independent of banks.

Los Osos CSD: Feasibility Gone Bad

- CSD created to build sewer as alternative to SLO County plan.
- Construction began in August 2005.
- Advance payments from State Revolving Loan Fund.
- CSD board recalled in special election.
- New board halts construction.
- CSD in default to Loan Fund in October 2005.
- State demands immediate repayment.
- Contractors sue for \$23 million in receivables.
- Regulators impose \$6.6 million in pollution fines.
- CSD files for bankruptcy in August 2006.
- AB2701 returns authority to SLO County.
- SLO bill: \$127 million or \$25,000 per homeowner

Typical Feasibility Tools

- Widely used by banks, accountants, government.
- Drawn from accounting and auditing:
 - ✓ historic and forward ratios
 1. Liquidity
 2. Asset management
 3. Debt management
 4. Profitability
 - ✓ produce pro-forma financial statements

Typical Feasibility Tools

- Debt service measures of particular interest:
 - ✓ debt service coverage
 - ✓ times interest earned
 - ✓ debt capacity analysis
- Debt capacity is the heart of the study
 - ✓ determines prudent level of total long-term debt
 - ✓ function of income and expenditure, including depreciation and rent

Typical Feasibility Tools

- Using accounting metrics, organization and lender can determine:
 - ✓ if organization can support added debt
 - ✓ prudent level of debt to add
 - ✓ whether to enter into debt financing
- Is project feasible financially?
- But is this the right question to ask?

Problems with Typical Feasibility T

- Accounting is a look-back discipline.
- Forecasts tend to be linear extrapolations.
- Assumptions go unquestioned and untested.
- No one wants to ask:
 - ✓ “What is the worst that can happen?”
 - or
 - ✓ “What if something goes wrong?”
- In practice, feasibility is mainly an accounting issue.
 - ✓ “It looks feasible, on paper.”

Problems with Typical Feasibility T

- Debt capacity analysis has weaknesses:
 - ✓ based on latest numbers
 - ✓ projects debt capacity far into future
 - ✓ discount based on single interest rate
 - ✓ analysis not related to forecast
- Answers wrong question: “How much debt can organization support now?”
- Question is: “How will borrower support debt burden during life of loan?”

The Problem in a Nutshell

- Feasibility: economic question of credit risk.
- Accounting methods do not model risk well.
 - ✓ narrow focus on cash flows
 - ✓ forward-looking analysis not a strength
 - ✓ too many variables and assumptions
 - ✓ too little focus on dynamic factors affecting decision
 - ✓ different mathematics
- Project risk is not addressed or understood:
 - ✓ “credit migration” events result

Is This Really a Problem?

- Look around you – classic credit squeeze.
 - ✓ banks reluctant to lend, even to banks
 - ✓ increasing cost of debt
 - ✓ sub-prime (high risk) lending meltdown
 - ✓ tightening credit standards
 - ✓ “credit migration” increasing
 - ✓ problem debt portfolios
 - ✓ credit models failing
 - ✓ credit ratings losing meaning
 - ✓ recession looming
- Increase demand for USDA services

Economic Feasibility Model

- Feasibility needs to address economic factors and risks affecting project:
 - ✓ micro conditions affecting revenues and expenditures
 - ✓ macro or market conditions (local, regional, national, international)
 - ✓ more focus on asset levels, not just cash flows
 - ~ optimal debt and equity levels
 - ~ exit strategy based on asset value

Fortunately, The Tools Already Exist

- Accounting model is starting point.
- Apply economic methods of analysis.
 - ✓ standard financial analysis models
 - ✓ standard economic forecasting models using probability analysis
 - ~forecasts expressed as ranges
 - ~use of scenario analysis, decision analysis, stress tests and worst case
- Apply project-wide risk analysis
- Develop risk strategies.

What Does This Mean for USDA?

- Look for feasibility study to answer these questions:
 1. “Will we get our money back?”
 2. “What are the chances of not getting our money back?”
 3. “What probability will we accept of not getting our money back?”
 4. “Does this project exceed our appetite for risk?”

Thank you.

For More Information:

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