Thromde Investment Plan

Municipal Finance and Management Component
Bhutan Second Urban Development Project (BUDP-2)

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1. Background

The World Bank has been supporting Royal Government of Bhutan by providing technical assistance to strengthen municipal management system under the Bhutan Urban Development Program II (BUDP II). The BUDP II project, through the World Bank's IDA Credit comprised of the following components:

a. Municipal Finance and Management
b. Thimphu Northern Area Development
c. Capacity Building

Under the Municipal Finance and Management, activities to strengthen and reform the institutional systems and financial processes in Thimphu and Phuentsholing Thromdes were undertaken. The main objectives of the activities were:

d. Strengthen local revenue administration through computerization and re-engineering business processes
e. Strengthen local government expenditure management and financial management systems and processes
f. Enhance accountability of Thromdes to citizens through regular performance reporting

The required activities are already completed in Thimphu and Phuentsholing Thromdes. Required financial management system, processes, manuals and guidelines are developed for Thimphu and Phuentsholing Thromde. Further, Revenue Management System (RMS) and Digitized Asset Register (DAR) are also developed and implemented in Thimphu and Phuentsholing Thromdes.

Additional Financing for BUDP II (Cr. 5431, USD 17.4 Million) is provided by the World Bank. With the additional financing works are being undertaken or planned to be executed under similar component of the main project as Municipal Finance and Management, Thimphu Northern Area Development and Policy Implementation Support. Through the additional financing activities to strengthen municipal finance management in Gelephu and Samdrup Jongkhar Thromdes are underway.

2. Introduction

Investment planning is a continuous process representing a complex set of activities that must be performed for the benefit of its effective and long-term development. In other words, the investment process (or activity) considered from a closer point of view can be understood as a process of the implementation of investment projects realized by the company. In particular, it is actually a process of acquiring the new tangible and intangible property, its modernization, reconstruction, innovation and expansion. From a wider point of view the investment activity implies also the process of making decisions on investments and simultaneously the process of searching, finding and implementing the overall company optimum characterized by the most effective exploitation of invested sources. Investment planning is a specific area of all its activities which are aimed to renew and expand the tangible and intangible property and, to a lesser extent, to put investments into the financial property, permanent increase in current assets, advertising, and the training of employees.

The decision on investments is a long-term process, in which the time factor must be considered. It has a great influence on the effectiveness of the whole organization activity, on the business sector, demand factor, and the over-all knowledge of external and internal conditions in which the investment is or will be realized. The investment activity is characterized not only by the above-mentioned areas but also by its specificities based on:

a. Organizational aims and objectives, which alter the combination of service set and lead to the increased effectiveness of expended sources,
b. Decisions in the long-term time horizon arising from the strategic planning, implementation of the business plan, and the operative plan,
c. Greater possibility of occurrence of some deviations at a higher risk and long-term consequences,
d. Capital-demanding operations which are beyond the instant investor possibilities,
e. Necessity to assess the investment comprehensively,
f. State support of the investment activity.

The financial aspect concerned with the organization’s decisions on investments is solved in the area of capital planning and long-term financing which involves:

a. Area of planning the monetary flows, i.e. capital incomes and expenditures from the realized investment,
b. Financial criteria for a choice of the project,
c. Consideration of the organizational risk during capital planning and investment decision-making,
d. Long-term financing of the company´s investment activity.

The basic element of planning the investment activity is the investment project characterized by:

a. Investment expenditures,
b. Expected incomes and expenditures during the lifetime,
c. Economic lifetime,
d. Residual value,
e. Ways of financing.

The investment project can include independent projects, complementary plans and the possibilities (variants) of implementing the investment plan.

3. Fundamental stages in the Investment

Preparation of the investment is based on the processing of the investment project when an organization thinks of the future, tries to anticipate events and consider eventualities. If the investment is suitably prepared, the enterprise can quickly and adequately react to changes in the surrounding environment. Therefore, the preparation incorporates such a solution which would include marketing, financial and managerial problems. The preparation is made correctly if the project:

a. increases the hope of the successful business activity and gives assumptions for the improvement of the long-term economic results in a firm;
b. decreases a danger of the project failure which could seriously threaten the firm´s stability and even its existence.

Therefore, this stage is very important for the organization´s success because in fact the point in question is the revaluation of service set and their provision factors, their utilization and possibilities to make the company transformation process more effective. Furthermore, this stage reveals the company an objective state of its activity and allows the aims of investments and the ways of their achievement to be realistically formulated.

Implementation of the investment proceeds after the plan of the project has been drawn up on a basis of the previous determination of data related to:

a. Tasks of the legal, economic and administrative character,
b. Interrelationships and the interconnection of individual tasks,
c. Time limits in which these tasks must be implemented,
d. Persons responsible for their implementation,
e. Financial sources which are necessary to ensure individual stages.

The process of managing the implementation includes primarily management and control processes, the character of which is changeable in dependence on the scope of the difference between the actual course of the implementation and the plan. On ensuring the project implementation a great importance is attributed to the information basis and to the necessary continual update and innovation in accordance with the development of the situation.

Project Appraisal for Investment

The methods used for the evaluation of investment projects and business aims are based on basic theoretical data materials. The bases are principles proceeding from the financial decision which is undertaken according to expected monetary flows. The principles should be based on incremental values and on depreciations of the long-term property; they should point out to the indirect consequences of investing and simultaneously to the fact that the flows of money from investments should include alternative costs. The flows of money associated with the investment project incorporate capital expenditures and capital incomes from the investment.

Capital expenditures:

a. expenditures on installation of the new investment,
b. expenditures on the permanent increase in current assets,
c. expenditures reduced by incomes from the sale of a substituted investment property influence on the income tax regime,

d. expenditures on the research and development, and also on the education of new employees,
e. capitalized interests, differences in the rate of exchange, and customs. Expenditures distributed temporally must be discounted to the present value.

Capital incomes:

a. profit increment arising after taxation due to the project implementation (sales increment, savings of costs, savings from the income tax), i.e. the contribution to the all-company economic results,
b. increase of depreciations,
c. changes in current assets,

It is necessary to respect also other principles of the financial decision, i.e. the factor of time value and the factor of risk. For the evaluation of the economic effectiveness of investment projects the methods considering the time factor are applied and from this point of view divided into static and dynamic.

The static methods are deduced from the application of the time value of money in the calculation of effectiveness and in the determination of a preferential order of the assessed projects.

The dynamic methods apply a concept of the time value of money considering the factor of the changeable value of money within time.

The methods considering the final effect from the investment are divided into:

a. methods employing cost criteria of the assessment,
b. methods based on profit criteria,
c. methods based on the money flow from the investment.

From the aspect of data accessibility in practice the application of methods based on the flow of money have proved to be the most applicable. The accessible and employed methods include: net present value, internal rate of return, payback period, profitability index, modified internal rate of return, discounted payback period.

The characterization of individual methods:

The net present value (NPV) at the absolute rate expresses a difference between the actualized (present) value of money incomes from the investment and the actualized value of capital expenditures on the investment. The actualized value of money incomes and capital expenditures can be denominated as a discounted money flow. The method of the net present value can be expressed also by a below-indicated algorithm indicating that:

a. the present value of all flows of finances generated by a given investment is defined; the last investment expenditures are actualized (bearing interest) and future net incomes from the investment are discounted (cleared of interest) to the present time; the rate for carrying and clearing of interest expresses capital costs (or the losses of lost opportunities), risks and the inflation rate;

b. the NPV is determined as a difference in the actualized money flows:
c. projects with a negative criterion value are considered to be disadvantageous;
d. the final decision on refusal or an acceptance of the investment project depends also on other factors (for example, an urgency of the investment, availability of financial sources, etc.) which are not considered in the method of the net present value.

In mathematical terms it can be expressed as follows:

$$NPV = [P1 / \{1+ i\} + P2 / \{1+ i\}2 + ... Pn / \{1 + i\} N] – C$$

Where, NPV = Net Present Value of the investment variant
Pn = money income in the individual years of lifetime
i = interest
n = individual years of lifetime
N = time of lifetime
C = capital expenditure

The internal rate of return: (IRR)

This method is denominated also as an internal percent of return. It can be defined as the interest rate in which the present value of money incomes from the investment is equal to capital expenditures on the investment.

In mathematical term it can be expressed as follows:

$$[P1 / \{1 + i\} + P2 / \{1 + i\}2 + . . . + Pn / \{1 + i\} N] = C$$

Meanwhile the net present value is based on the given interest rate, the internal percent of return is achieved by searching for the interest complying with the equality of discounted money incomes and expenditures. It follows that the method indicates at what interest rate is the net present value of the investment project equal to zero.

Payback period (reimbursement period): (PP)

It is the traditional method of assessing the effectiveness of investment variants which is often used in practice but less important from the theoretical point of view. The payback period can be defined as the number of years during which the capital expenditure is paid off by money incomes from the investment. The investment having a shorter payback period is considered more favourable. This method can lead to the incorrect decision on the choice of variants because it:

a. disregards money incomes from the investment which are produced during the payback period and thus distorts a view of the effectiveness,

b. usually does not respect the time factor nor the time value of money,
c. prefers variants with a shorter lifetime despite their lower effectiveness.

By means of the payback period only investment variants with an equal lifetime period and an equal course of money incomes from the investment can be chosen. In that case the actually shorter payback period is derived from the higher effectiveness.

How do you correctly choose the method which you intend to apply? On asking such a frequent question the reply to it should involve your willingness to undergo a risk. In order to ascertain a dimension of the expected risk, it is necessary to define the investment characterized by returns, liquidity and a risk as the last factor. The return represents a growth of the enterprise´s market value detected by NPV and IRR methods. The risk represents a danger resulting from the fear that the achieved business results will differ from those which are predicted. The liquidity represents the payable ability or else the time of releasing invested sources. In practice, there is a search for such projects which give the maximum return at the acceptable rate of risk. For measuring and managing the risk it is necessary to know its types and causes of its emergence. The managing of the risk proceeds from the effort to minimize or eliminate its occurrence, namely by removing the causes of its development and by reducing its unfavorable consequences to an acceptable measure. However, everything should be done on the assumption that a risk will be considered already during decision-making. Example: The investor asks for a certain premium as a compensation for bearing the risk which reflects in the required return, i.e. he asks either for a risk-free return or a risk premium. Every investment is acceptable for him as long as it is valid that the expected return from the investment ≥ required return.

4. Risk and Return

What is risk?

The meaning of risk can vary. For some it may mean the possibility of losing a portion of their investment due to market movements or a poor decision. For others it may mean not enough income is produced from the investment. Another measure of risk is the variability of returns over time known as volatility. Generally, risk can be viewed as the chance of failure in achieving objectives or goals. Risk is part of investing. Importantly it can be measured and managed within an investment portfolio. Taking on some risk is necessary for higher returns. The main concern is to determine the appropriate level of risk for you. Taking on greater short-term risks may be necessary to receive the long-term returns needed to achieve your lifestyle goals and objectives. Taking on too much may prove to be a mistake. Taking on too little may cause regret and failure to achieve the returns needed to meet your lifestyle goals.

What are the types of risk?

There are a number of risks to be considered when constructing your portfolio such as:

Investment market risk
The possibility all investments in a market sector, (such as shares), will be affected by an event.

Investment specific risk
The possibility a particular investment may underperform the market or its competitors.

Market timing risk
The possibility your investment may be sold at a time when the sale price is at a low-point or purchased when the sale price is at a high-point.

Inflation risk
The possibility your investment return is below the inflation rate which reduces the spending power of your money.

Credit risk
The potential failure of a debtor to make payments on amounts they have borrowed.

Interest rate risk
The possibility your investment will be adversely impacted by a fall or rise in interest rates.

Legislative risk
The possibility a change in legislation will impact the appropriateness of certain investments for you.

Liquidity risk
The ease with which you can sell or liquidate your investments. Some investments impose exit fees or have limitations on withdrawals. Other investments may be difficult to sell due to a lack of buyers.

Hedging risk
A technique designed to reduce the risk from part of an investment portfolio often by using derivatives. While hedging can reduce losses, it also has a cost and therefore can reduce profits.

Currency risk
Relates to global investments. It is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Derivatives risk
Where financial derivatives are used as an alternative to directly owning or selling underlying assets in order to manage risk and/or enhance returns. Risks associated with derivatives can include; the value of the derivative declining to zero; the value of the derivative not moving in line with the underlying asset and, the derivative may be difficult or costly to reverse, and

Opportunity cost
The investment return you may forego from an asset as a result of investing in your preferred asset. That is, there is a risk the preferred asset you invest in may not return more than the second-choice (next best alternative) asset you did not invest in.

The relationship between risk and return

Risk and return are closely related. In general, the higher the degree of risk associated with an investment, the higher the return required by investors to accept this risk. Low risk investments such as cash offer relatively low returns as a reflection of their greater security. This is called the risk/return trade-off. Investment offers lower expected return with lower risk compared to investment B which offers higher expected return with higher risk. All investments and asset classes have different levels of risks and expected returns. For example, low risk investments like cash generally provide a lower return than high risk investments over the long term but are unlikely to lead to a capital loss. High risk investments generally offer the potential of a higher return over the long term but there is a higher chance that high risk investments will be more volatile in the short term (leading to capital loss if investments are sold in the short term).

5. The Thromde Investment Avenues

The Local Government Act and the Municipal Finance Policy allows for Thromdes to make investments and raise revenues to enable it to move toward self sufficiency. However, there are several conflicting Acts and policies in place, observed by various agencies in the country, posing a major hindrance or sometimes even disallowing the Thromde from raising finance.

For instance, any increments in the property taxes, fees and charges can only be proposed by the Thromde authorities while the power of revision vests with the parliament only. Similarly, while some Thromdes have maintained surplus funds in short term, interest bearing deposits, objections have been raised by the Department of National Budget and the Royal Audit Authorities regarding the legitimacy of the same. Further, the ownership of natural resources such as forestry, mines and minerals, sand etc are with the Natural Resources Development Corporation while properties and real estate is the prerogative of National Housing Development Corporation.

The Thromdes have not been able to invest their surplus funds in the financial markets owing to the fact that they have had to source grant funds from the Royal Government, who is not keen on making easy allowance for the investment of public funds into these risky portfolios.

Notwithstanding the above, the following are some of the ways in which the Thromdes can park idle funds in investments that fetch them good returns.

Capital Market

Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions. Capital markets help channelize surplus funds from savers to institutions which then invest them into productive use. Generally, this market trades mostly in long-term securities. Capital market consists of primary markets and secondary markets. Primary markets deal with trade of new issues of stocks and other securities, whereas secondary market deals with the exchange of existing or previously-issued securities. Another important division in the capital market is made on the basis of the nature of security traded, i.e. stock market and bond market.

As opposed to primary markets, the risks associated with secondary market is relatively lower since historical records provide a good basis of judgment.

Government bonds are very safe investment instruments. However, owing to the low volatility of the Bhutanese capital market, investments in corporate bonds are fairly safe.

Overall, an assessment of the expected returns must be made diligently. It is worth taking the following cautionary notes.

a. Investing in a single share or a very small number of individual shares is more likely to expose you to greater fluctuation in the value of your investment than investing across a range of shares. It is possible to further reduce fluctuations by investing across different sectors in the economy.
b. Small companies are generally considered higher risk investments.
c. Share prices can rise and fall suddenly in response to many factors including company profits, market sentiment, industry issues and economic trends.

Money Market

Money market basically refers to a section of the financial market where financial instruments with high liquidity and short-term maturities are traded. Money market has become a component of the financial market for buying and selling of securities of short-term maturities, of one year or less, such as treasury bills and commercial papers. Over-the-counter trading is done in the money market and it is a wholesale process. It is used by the participants as a way of borrowing and lending for the short term.

Money market consists of negotiable instruments such as treasury bills, commercial papers. and certificates of deposit. Around the globe, it is used by many participants, including companies, to raise funds by selling commercial papers in the market. In the Bhutanese context however, CPs and CDs are not popular instruments. The Central Bank, as a monetary policy measure, frequently offers Treasury Bills which are very safe.

Money market is considered a safe place to invest due to the high liquidity of securities. It has certain risks which investors should be aware of, one of them being default on securities such as commercial papers.

Money market consists of various financial institutions and dealers, who seek to borrow or loan securities. It is the best source to invest in liquid assets. The money market is generally an unregulated and informal market and not structured like the capital markets, where things are organised in a formal way.

Money market gives lesser return to investors who invest in it but provides a variety of products. Withdrawing money from the money market is easier.

Money markets are different from capital markets as they are for a shorter period of time while capital markets are used for longer time periods. Meanwhile, a mortgage lender can create protection against a fallout risk by entering an agreement with an agency or private conduit for operational, rather than mandatory, delivery of the mortgage. In such an agreement, the mortgage originator effectively buys an option, which gives the lender the right, but not the obligation, to deliver the mortgage. Against that, the private conduit charges a fee for allowing optional delivery.

Term Deposits

Parking the surplus funds in fixed deposits is very common. Some Thromdes have even made use of this investment avenue.

While the frequency of its use had been fairly high and that they are very safe, attention is drawn to the following:

If the interest rate at which the funds are invested is 5% but the annual inflation rate is 7%, then following the NPV and IRR principles, the returns are not worthwhile. It is therefore wise to weigh alternate investment avenue in terms of expected rates of returns.

Natural Resources

As mentioned earlier, the proprietary rights to natural resources vests with another agency, notwithstanding its location within the country. So, at its initiation, the Thromdes will need to work earnestly towards gaining the title to its use rights to the use of natural resources within the Thromde jurisdictions.

Thereafter, the Thromde needs to invest in plant and machinery and the necessary infrastructure to avail the financial gains, over a period of time, from these resources. The Thromde will need, however, to ensure ethical use of these assets.

Housing and Real Estate

Housing is problem in most municipalities across the country. Acknowledging this issue and with an objective to serve its citizens, the Thromdes could invest in real estate targeted to meet the housing demands, especially of low- and middle-income group citizens.

Once again, the principal task for the Thromde is to transfer the ownership rights from NHDCL and/or other affected agencies of the existing properties lying within the Thromde boundaries. They must also seek legal admissibility to make investments in building housing colonies. This is certain to meet the dual objectives of seeking financial sustainability over a long period of time as well as serving its needy citizens.

So, there are two options

a. Acquisition of existing properties

b. Building new properties.

Do keep in mind the following words of caution which will aid in planning the investment better.

a. Large amounts of capital are required to purchase a direct property.
b. There are significant establishment costs and ongoing costs associated with maintenance of the property.
c. Direct property assets can be illiquid, resulting in the inability to draw down a portion of your capital in the future.
d. You risk being heavily reliant on the income stream from a single investment sector.
e. You risk losing income whilst the property is untenanted.
f. As a significant amount of capital is required to purchase a direct property, your portfolio may lack diversification.

Adoption of PPP models

One very noticeable aspect of the Thromdes, especially at GT and SJT is that general public sentiments are awkwardly low in terms of investing in these areas. They feel that there is barely any economic stimulus to invest. A security threat is the primary investment concern. It is however true that security threats can be contained collaboratively and a strong market stimulus needs to be provided.

Thromdes have been waiting for entrepreneurs to come in and the wait has been fairly long by now. It is therefore proposed that Thromdes come up with small manufacturing plants, export oriented or otherwise, and finance them through Municipal bonds where general public and enthusiastic entrepreneurs can be a part of the project with multifaceted objectives such as employment generation; increase the basic living standards of the local population, etc.

Infrastructure assets

Religion and Health are the two of the most primary aspects of peoples' livelihoods. Hundreds of thousands of common citizens flock to hot springs believing that these hot springs rinses off their illnesses, interior or exterior. Even more people flock in from all corners of the country to receive ritualistic blessing of a *Moenlam Chenmo*.

The Thromdes can take lifestyles as an opportunistic asset and design to make an investment in areas that will attract the general public.

For example, thousands of Bhutanese visit Siliguri or Bangkok every year in the pretext of a family vacation. They take their children to zoos and water parks. Can the Thromde capitalize on these changing lifestyles and build water parks and zoos, for example, and market them in such a way that people choose to omit visiting abroad for family vacation and choose a place that is nearby but equally fun-filled? The design can be tourism oriented as well.

6. Investment Policy

The following elemental aspects need to be heeded by all accountable personnel of the Thromdes with regard to making an investment.

a. Integrity: Due diligence must be observed to ensure integrity in the investment management process.
b. Legality of Investments: All investment activities must conform to the Local Government Act and the Thromde Finance Policy. This ensures the legality of the investments.
c. Minimization of Risks: A proactive policy to minimize the risk of incurring a capital loss and of preserving the value of the invested principal must be formulated. This is accomplished by investing in properly rated financial instruments as per the legislation, by limiting the types of investments to a maximum percentage of the total portfolio, and by limiting the amount invested within individual institutions to a maximum percentage of the total portfolio.
d. Maintenance of Liquidity: The term liquidity implies a high degree of marketability and a high level of price stability. The portfolio is structured to maintain a proportionate ratio of short, medium and long-term maturities to meet the funding requirements. The investment portfolio shall remain sufficiently liquid to meet all operating or cash flow requirements and limit temporary borrowing requirements. This shall be done where possible by structuring the portfolio such that securities mature concurrent with anticipated cash demands. Furthermore, since all possible cash demands cannot be anticipated, the portfolio shall consist largely of securities with active secondary or resale markets. Therefore, important liquidity considerations include a reliable cash flow forecast outlining timing requirements of funds, a contingency to cover the possibility of unplanned requirement of funds, and an expectation of reliable secondary marketability of investments prior to maturity. If cash flows are unpredictable, liquidity should be kept high in order to cope with unplanned events.

It is therefore cardinal that the Investment of Organizational funds conforms to the following objectives

a. To manage cash flows in an efficient and prudent manner
b. To maintain a level of liquidity sufficient to meet both planned and unforeseen cash requirements
c. To invest only in approved financial institutes
d. To minimize the risk of investments
e. To maximize returns on investments without incurring undue risks
f. To ensure all relevant information is disclosed to Thromde Citizens through the Thromde Tshogde
g. To ensure that all investment decisions are made by the appropriate delegated authority
h. To prohibit investment of funds for speculative purposes
i. To ensure transparency and compliance in all investment processes