INDIAN INSTITUTE OF MANAGEMENT KOZHIKODE

Case Study

IIMK/CS/250/FIN/2024/04

March 2024

Portfolio Approach for Selecting Financing Method: Corporate vs. Project Financing

Nemiraja Jadiyappa [1]

[1]Associate Professor, Finance, Accounting and Control area, Indian Institute of Management Kozhikode, IIMK Campus PO, Kunnamangalam, Kozhikode, Kerala 673 570, India; Email: nemiraja@iimk.ac.in, Phone Number - 0495 2809446

Portfolio approach for selecting financing method: Corporate Vs project financing

Nemiraja Jadiyappa[1]

Abstract

This case helps the participants in solving a managerial dilemma regarding the type of financing to be used to fund their new project. It involves a choice between corporate financing and project financing. The participants, first, will understand what corporate financing and project financing are, the difference between them and then their advantages and disadvantages, and finally, how to select one between them. As this question is essentially related to risk and return trade-off for the sponsoring firm, thus, it uses a portfolio approach to solve this decision dilemma. The participants will experience how project financing helps the sponsoring firm mitigate its risk.

The company

Jaramine Ltd is a major player in the petrochemical industry in India. Though not the biggest firm in the petrochemical industry, it has established itself as a major player in India. Established in 1981 with a small PVC plant in the Chitradurga district in Karnataka, it has grown by many folds in organic as well as inorganic ways through backward and forward linkages. Currently, it operates a refinery with 1.2 million barrels per day capacity. It also owns a chain of retail outlets across the country. The oil is supplied to major cities using the oil pipeline operated by a consortium of oil companies, including Jaramine Ltd. Apart from these, it has many subsidiaries which are involved in the production of petroleum products. As of 2022, it has an asset base of Rs. 18956 Cr and clocked Rs. 38105 Cr in sales. It has a healthy operating margin of 13%, and its shares, listed on the National Stock Exchange, are trading at Rs. 269.30 per share, which is 2.3 times its book value.

The management of Jaramine Ltd, traditionally headed by a member of Mr. Nemiraja's family, is always averse to taking highly risky policies. In line with this motive, their current ratio always remained above 1.5, and they always used debt very conservatively. In 2022, their debt ratio is 25%, which is way lower than the industry average of 60%. The high capital intensity of the industry, i.e., a higher proportion of fixed assets, and high free cash flow margin support

[1] Associate professor, Accounting, Finance and Control, Indian Institute of Management Kozhikode, Email: nemiraja@iimk.ac.in

such higher debt ratios. Because of such a low debt ratio, the firm enjoys a very healthy AAA credit rating.

Industry

The petrochemical industry in India is dominated by five major players, of which, three are in the public sector. Jaramine Ltd is the fifth one among these top five. All these firms, except Jaramine Ltd, have their presence in upstream as well as downstream activities. Jaramine Ltd doesn't own any oil fields, and thus, it depends on imported crude oil for its business. Other firms, on average, use 30% of crude oil produced in domestic oil fields. Given the geopolitical issues in the global oil market, it is always a big challenge for Jaramine Ltd to manage such risks. However, the Indian government's recent energy cooperation agreements with most of the Gulf countries and cheap oil flowing from Russia have eased crude oil supply risk. However, currency exchange risk continues to be a major concern for these firms[2]. Also, the use of petroleum products is cyclical, thereby making the cash flows from this industry very volatile. Apart from all these, growing concerns about global warming have made electric vehicles very popular, especially in the two-wheeler segment presently. The government is also planning to introduce tougher emission norms to address this issue, which would likely increase investments in green technologies in the petroleum industry.

The project

Recently, Jaramine Ltd won the bid to develop an oilfield in the Tungabhadra basin. The project is expected to last for about eight years from the day of operation. In the base case scenario, it would have a capacity of 50,000 barrels per day in the first year of production and go up to 125,000 barrels per day from 6th year onwards. However, in the worst-case scenario, the production could be 25% less than the base case. It requires about Rs.7500 Cr in initial investment, spread across two years, to develop this field. From the strategic perspective, the project seems to fit perfectly with their objective of having their presence at all the points in the petroleum industry value chain. They can trade in domestic crude among other firms to carry the crude produced in this field to the nearest refinery using the existing oil pipelines. The company has done economic and financial feasibility analysis and found the project to be very attractive financially. The cash flow margin varies between 60 to 70% of the sales. The board of directors and all major institutional and retail shareholders have given their approval

---

[2] They do use forward contracts to manage currency risk, however, geo political conflicts have made such arrangements a double edged sword.

for developing this project. The market price of the shares went up by about 7% when Jaramine Ltd won the bid.

The CEO of the firm, Mr. Vishruth Gonchikar, the eldest son of the founder of the group, Mr. Nemiraja, has been asked by the board to prepare a detailed report on how to operationalize this project and ways of financing it. The board directed him that the financing plan should adhere to the basic norms of the group regarding the financing policy. Mr. Gonchikar, while evaluating the project, noticed that the free cash flow margin of this project is substantially greater than its existing operations but, at the same time, is more volatile. Further, he noticed that the Tungabhadra basin has a history of violent civil unrest, which might result in construction delays. His main concern is the impact of the higher volatility of this project on the cash flows of the existing firms. Further, he is worried about the scale of the investment. He believes that the cash flows from current operations may not be enough to finance a major part of the project using equity, and hence, a major part of the financing has to be from debt sources. There is also concern that he may have to accommodate other partners, as Jaramine Ltd. Needs the technology or expertise to develop and run oil fields.

In this context, he is facing an important question regarding the type of financing to be used that would address his concerns. Basically, his choices revolve around corporate and project financing. Each of them has its advantages and disadvantages, and none of them would address all his concerns alone.

Additional Information

Exhibit 1: Projected demand for petroleum products in India[3]

Year	2023	2024	2025	2026	2027	2028	2029	2030
Demand (MBPD)	5.5	5.63	5.78	5.95	6.11	6.28	6.46	6.64

Exhibit 2:

Select financial information of Jaramine Ltd	
	2022
Total Sales	38105
Assets	18956
Fixed assets	15164.8
Current assets	3791.2
Current liabilities	2508
Debt	4739
The market value of equity	26930.7
Debt Rating	AAA
EPS	10.6
PE	11
MB of equity	2.3

Exhibit 3:

Projected sponsor FCFE		Projected project FCFE	
Year	FCFE	Sales	FCFE
2023	7689		
2024	8073		
2025	9780	6500	4550
2026	10269	7150	5500
2027	6574	7865	4500
2028	6903	8600	5600
2029	7248	9460	6500
2030	7610	10400	7280
2031	8923	11000	7800
2032	9369	12100	8500

[3] https://economictimes.indiatimes.com/industry/energy/oil-gas/india-to-be-largest-global-oil-demand-growth-driver-through-2030-iea/articleshow/107480937.cms

Research Office
Indian Institute of Management Kozhikode
IIMK Campus P. O.,
Kozhikode, Kerala, India,
PIN - 673 570
Phone: +91-495-2809237/ 238
Email: research@iimk.ac.in
Web: https://iimk.ac.in/publications