

"A man is
great by
deeds, not by
birth"
-Chanakya

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Case Study

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**Building a New OFC Network by Samskruti Ltd:
How Does Project Financing add Value to the Sponsor?**

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Nemiraja Jادیappa¹

Abstract

This case helps students understand how project financing could be used to enhance value by corporate firms. In other words, how project financing adds value to a firm vis-à-vis corporate financing. Participants will understand in what state of the world project financing adds greater value to the sponsoring firms compared to corporate financing. By using the classical firm value function, i.e., $V=FCF/r$, the case demonstrates to participants that project financing adds value to the sponsor from both the cash flow and discount rate channels. The participants would then link value creation to capital market imperfections like information asymmetry, adverse selection, and agency problems. The case could also be used to discuss some of the disadvantages of project financings, which might actually have a negative impact on firm value.

The company

Samskruti Ltd is a dominant player in the telecom industry in India. The management of Samskruti Ltd, traditionally headed by a member of Mr. Nemiraja's family, is always very aggressive in its business operations and expansion plans. It occupies the second position after Gonchikar Ltd, with a market share of about 25%. It dominates the market in south India and occupies the third position in northeastern India. In the rest of India, it is in second position. Established in 1981 with a small OEM plant in the Hiriyuru, Chitradurga district of Karnataka, it has grown by many folds, mostly in inorganic ways, i.e., through mergers and acquisitions. Most of this growth has been financed using corporate financing by creating subsidiaries.

To support its activities, the firm has about 15000 mobile towers spread across the country. However, it uses leased optical fiber cables (OFCs) for its operations. The firm clocked a turnover of Rs. 29652 cr with a net profit margin of about 6.8%. The average revenue per customer is about Rs. 280 which is 12% greater than the industry average. Currently, most of its network uses 4G bandwidth, which the firm purchased from the Government of India for about Rs. 26000 cr in 2015. At the end of the financial year 2022, the firm has invested about Rs. 32350 cr in total assets, of which Rs. 15625 is the spectrum balance, which is still to be

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capitalized. Debt from banks is the major source of financing, and it contributes about 36% of the overall capital and debt from other sources makes another 18%. This total debt ratio of 54% is about 6% less than the industry average. The firm enjoys a credit rating of A or equivalent from all the major credit rating agencies. The stocks of the firm are listed in NSE and BSE and are priced at Rs. 185, which is three times its book value and 12 times relative to 2022 EPS.

Industry

The telecom industry in India is dominated by three major players, one of which is in the public sector. The government of India liberalized the telecom sector in the early 2000s, and since then, the sector has shown tremendous growth over the years and more or less become saturated by the end of 2021. The average growth of the industry from 2000 to 2015 is about 15% which has slowed down to about 6% after 2015. This corresponds directly with the population coverage. By the end of 2022, the industry has about 1211 million active users. Very fierce competition in the industry has made Indian telecom firms the cheapest providers of voice and data services. The industry has gone through several shifts in terms of demand and technology. The demand for mobile voice dominated the industry till 2015; since then, the demand for data has become a growth driver. The government of India has auctioned 2G, 3G, 4G, and, recently, 5G spectrums in the open market to make data transmission more efficient. These frequent changes in technology associated with different spectrums have made huge investments essential for survival.

The project

The government of India has recently allotted the firm 5G spectrum to Samskruti Ltd. However, the firm is facing major issues in using this spectrum. Till now, it was using a leased OFC for data transmission. However, given the expected growth in the volume of data that is required to be transmitted across India, the existing OFC infrastructure would be inadequate to meet even 30% of the expected demand. Facing this issue, the CEO, Mr. Gonchikar, has proposed building a green field 10000km long OFC network that would connect north with south and east with west. A typical OFC network has a useful life of about 15 years, and then it has to be replaced with new kinds of cables. The estimated cost of this project is about Rs. 5000 crores. The firm does not have expertise in building such an infrastructure and, hence, is planning to go joint venturing with Vishruth Data Cables Ltd. They plan to build an OFC network with an installed capacity of 1024 GBPS with an initial capacity of 256 GBPS.

Samskruti Ltd is expected to use about 35% of the total capacity and the rest of the capacity would be sold to other players.

The CEO Mr. Gonchikar, is evaluating this project and has to decide about how to structure and finance this project. He has two options. First, he can structure it as a part of the firm and finance the project using the balance sheet of Samskruti Ltd. However, he feels that this is not a feasible solution as it has the potential to destroy the current market value of Samskruti Ltd and expose it to potential bankruptcy. The alternate way that he is thinking is project financing. But, the firm has never used this financing till now and the board is generally opposed to it. The board wants to finance this project using corporate financing. Mr. Gonchikar now has to convince the board that Project financing adds more value to the firm compared to corporate financing. Specifically, he has to tell them how project financing creates more value than corporate financing.

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Additional Information

Figure 1: Growth in demand for voice and data business

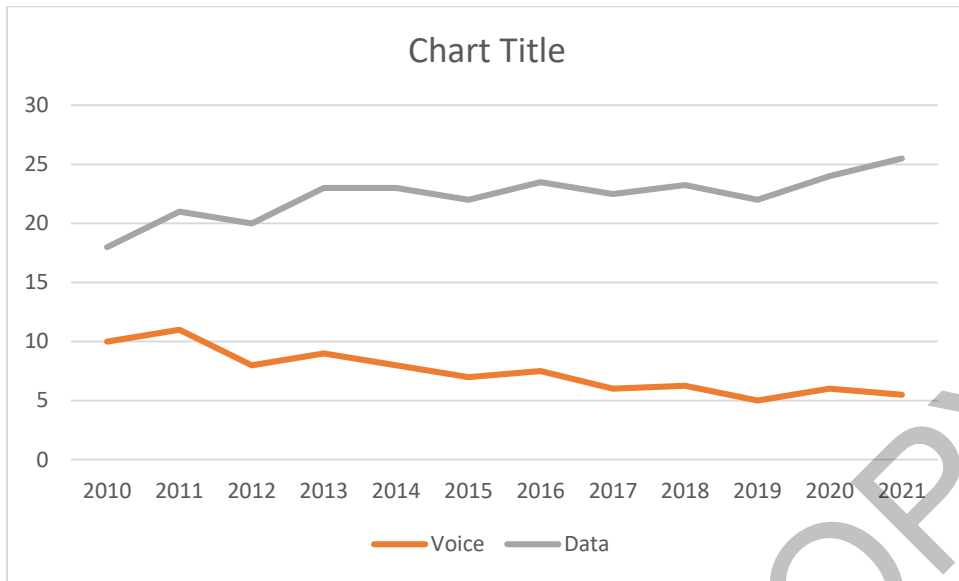


Figure 2: Expected demand for data service

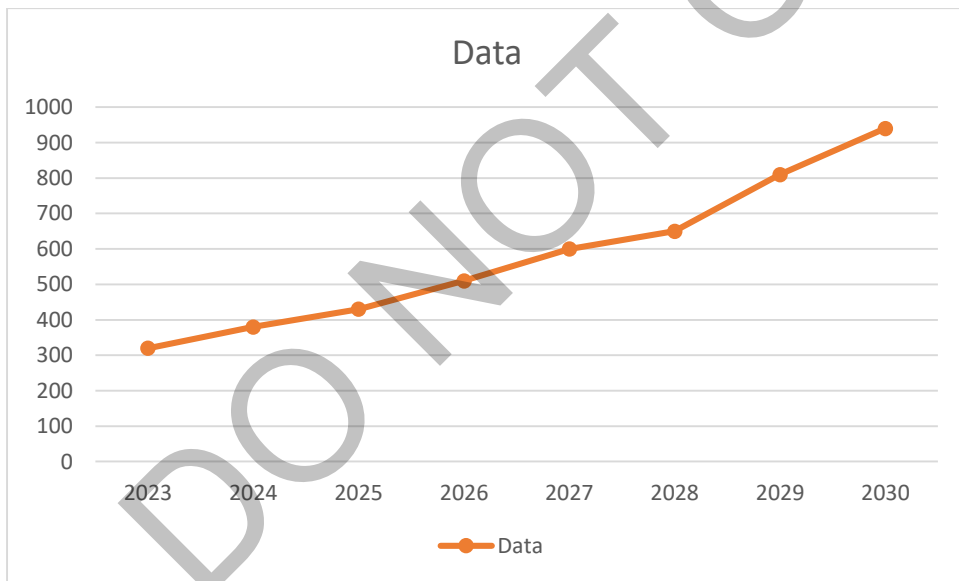


Exhibit 2:

Selected information about Samskruti Ltd	
	2022
Total Revenue	29652
Assets	32350
Fixed assets	26758
Current assets	5592
Current liabilities	4823
Debt	17469
The market value of equity	44643
Debt Rating	A
EPS	15.41
PE	12
MB of equity	3

Table 2: Investment requirement

Investment	5000 cr
Lifespan of the project	15
Length of the OFC	10000km
Data Transmission potential	1024 GBPS
Operating margin	75%
Depreciation	Straightline



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