

FINANCING STRATEGY ANALYSIS TO MAXIMIZE COMPANY'S VALUE CASE STUDY: PT ABC

Jemmy Wangsaputra and Subiakto Sukarno
School of Business and Management
Institut Teknologi Bandung, Indonesia
jemmy.wangsa@sbm-itb.ac.id

Abstract— *As a newly born mining company, PT. ABC needs more funding to finance the capital expenditure. The capital expenditure is needed in order to ramp up the company production capacity. The current 0.5 Million Ton 2012 production cannot meet their target capacity which is 2.3 Million Ton. So, they need the additional funds to finance the capital expenditure immediately. The fund needed is approximately 5 Millions USD. There are two source of funding alternatives, which are internal and external sources. The internal source which is retained earnings is not possible due to the insufficient funds. The possible external sources are bank loan and advance from customer. So, there are three possible forms of financing alternatives for PT. ABC, which are bank loan, advance from customer and the combined of both bank loan and advance from customer. The concern for the company is they have a plan to become publicly traded company in near future, so this immediate financing need should be aligned with the company medium and long term plan. The parameter that needs to be analyzed from every alternative is the impact on company value. The company value of every alternative is analyzed using DCF (Discounted Cash Flow) method and Relative valuation method. Based on the analysis using DCF and Relative valuation method, the best possible alternative is the combined of both bank loan and advance payment. That alternative resulted in the highest equity value which ranged between Rp 2,421 Billions to Rp 3,556 Billions.*

Keywords: Funding Alternatives, Discounted Cash Flow Valuation, Relative Valuation

1. Introduction

Demand of power all around the world is always increasing year by year. There are two sources of power, renewable resources and un-renewable resources. Even though renewable resources are now being encouraged, the portion is still small compared to the un-renewable resources. So, the un-renewable resources are still the most valuable commodity. There are several kind of un-renewable resources, some of them which are quite popular are oil, gas, and coal. Coal is commonly used by power plan to produce electricity. As the demand for coal is still huge, the coal mining company is continuously increasing their production capacity.

PT. ABC is a newly developed mining company which operates in Kalimantan. ABC is a fiction name only to be used in this research as demanded by the real company to protect the company's confidential data. The project is located in the East Kalimantan Province, Indonesia. The project is approximately between the capital city of East Kalimantan, Samarinda, and the sea-port city of Balikpapan. PT. ABC was approached by the Government of Indonesia as a potential developer of the coal resources of the area. Beginning in 2008 and continuing through 2011 PT. ABC undertook exploration studies and baseline studies. This baseline studies are ongoing and will continue into 2016. PT. ABC applied for the mining concession in 2006. In 2005 the block was awarded to PT. ABC. Following a more definitive exploration program, PT. ABC started mine infrastructure development in 2009; stripping and coal production in 2010.

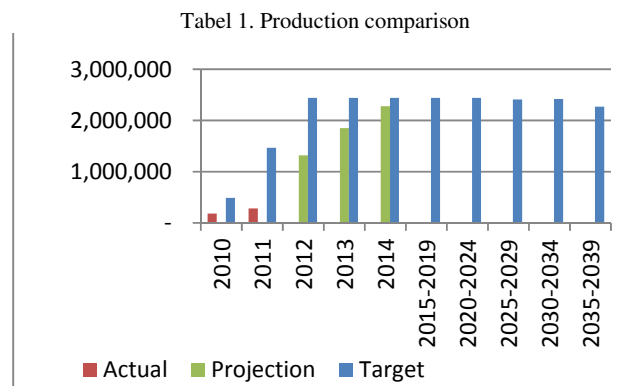
Primarily, the company is in start up phase, so they need to expand their production capacity rapidly, but the actual condition didn't go as planned. The first and second year production shows that the

company is expanding too slowly. So they need some extra performance to meet their capacity target for the following years. In order to expanding the production capacity, they need additional capital expenditure to build more infrastructures. PT. ABC cannot finance the additional capital expenditure by their own cash flow, so they looked for other source of financing. The current funding alternatives are in form of bank loan, advance from customer and also the combination of both bank loan and advance from customer.

The issue now is PT. ABC has a plan to go public in near future, and the company doesn't want this immediate capital expenditure funding jeopardize the IPO plan. Even, if possible, this capital expenditure funding should accommodate the IPO plan to be more achievable. Regarding the considerations above, PT. ABC needs to find out which form of capital expenditure alternatives will result in better company valuation. So, the business issue of PT. ABC is about how to choose the capital expenditure funding alternatives in order to maximize the company value. Which forms of funding is the most suitable option.

2. Business Issue Exploration

PT. ABC is now on the third year since starting their production. Before they started the production, they already have planning or target that they need to follow. The plan is based on their concession situation, the terrain, and historical data of other comparable mining company. With the 69.2 million tons reserves, the company planned to do the exploration for 30 year. As the company production started in 2010, the actual realization of the target production didn't go as planned before. The company is struggling to meet the targeted exploration capacity. Figure 2.1 shows the production capacity comparison between the target, actual, and 2012 till 2014 projection.



In order to increase the production capacity, the company needs to lean out their production line, build more infrastructures and provide more equipment needed. To finance those needs, the company needs additional source of funds.

A. Conceptual Framework

The conceptual framework of this research is used to explore the business issues of PT. ABC which is related to funding issue. By deeply exploring the issues, the root cause can be found, and the solution can be formulated.

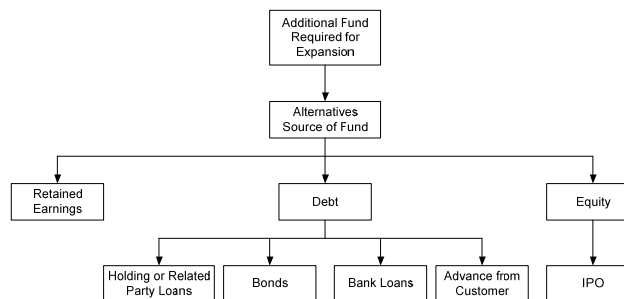


Figure 1. Conceptual Framework

Basically, the first source of fund for a company is retained earnings, which is the internal source of fund. Sometimes retained earnings are insufficient to finance rapid expansion or big projects of the company. When retained earnings are no longer sufficient, the company will start to consider looking for external source of fund. These external sources of capital are in form of debt or equity. For debt itself, PT. ABC has three possible alternatives, which are loan from holding company or related party, corporate bonds, and loan from banks. For equity form source of capital, the company is only considering IPO (Initial Public Offering).

B. Method of Data Collection and Analysis

The needed capital expenditure can be fulfilled internally or externally. The internal source of fund is retained earnings. The external sources of fund are debt and equity. For debt itself, the company has several options, which are holding or related party loans, corporate bonds, and bank loans. For equity, the only considered option is IPO.

- **Retained Earnings**

The actual and forecasted retained earnings are shown in Table 2.4. The capital expenditure needed is 86 Billions rupiah. The forecasted retained earning for 2012 is only 45 Billions rupiah, so it is insufficient to finance the capital expenditure.

Tabel 2. Retained Earnings (in Millions Rupiah)

	2010	2011	2012	2013	2014
	A	A	E	E	E
Deficit					
/					
Retained Earnings	(3,261)	(5,434)	45,462	100,419	144,611

- **Holding or Related Party Loan**

For the past few years since PT. ABC is established, the kind of debt the company used is only shareholder loan. For this kind of debt the company got no interest rate, or in other word they don't need to pay the interest. In 2011, the company just converted 90 billion rupiah shareholder loan into equity. And now the holding just stated that they won't give another loan. So, shareholder loan can't be used to finance the capital expenditure.

- **Bank Loan**

PT. ABC, they are already passed the feasibility test of several banks. Many banks willing to give them loan, it's just a matter of which bank will give the lowest interest rate. And until now, the most possible choice is BNP Paribas, because of the good relationship between them.

- **Corporate Bond**

PT. ABC is newly established company, and hasn't scores a profit since the establishment, the rating is obviously will be very bad. In order to make people buy bad rating bonds, the coupon rate must be high, and make it very expensive source of fund. Therefore, because of this reason, the corporate bond alternative is worse than debt.

- **Advance from Customer**

The mechanism for advance payment is much simpler than bank loan. The collateral is the coal reserve which will be sold to the customer in the next certain period. Since PT. ABC is a newly established mining company, and the financial condition hasn't showing good performance, it will be easier to get the advance payment rather than bank loan.

- **IPO**

For the immediate capital expenditure need, IPO is not a suitable option. First is because the fund needed for this immediate capital expenditure is relatively small compared to the IPO scale. Second, IPO is a complicated process which needs relatively long time, and this capital expenditure is needed immediately.

After developing conceptual framework, student is required to analyze every factor contained in the framework. These details will assist any readers to conceive business situation of the company/industry. In order to improve reliability of its description, author should explain the required data base and method.

C. Analysis of Business Situation

After analyzing the business issue of PT. ABC, the points that need to be considered are:

- PT. ABC needs additional funding to finance their capital expenditures
- There are several forms of funding that available, which are bank loan, advance from customer and the combined of both bank loan and advance from customer
- The concern for this immediate funding is the alignment with company medium and long term plan which are going to be publicly traded

3. Business Solution

PT. ABC is now needs immediate financing. There are several options that PT. ABC can choose in order to get the immediate financing, which are bank loan and advance from customer. The factor that needs to be considered the most is that this immediate financing should be aligned with company medium and long term plan. PT. ABC has a plan to become publicly traded company in the future in order to fulfill the company expansion needs.

D. Alternative of Business Solution

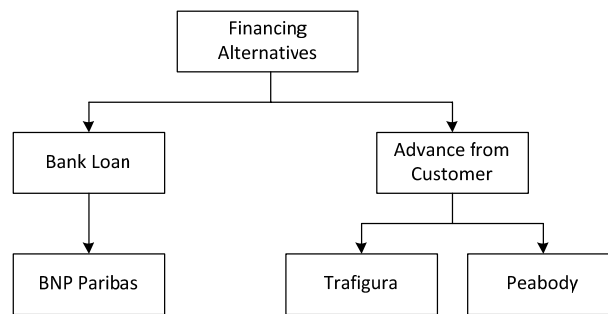


Figure 2. Immediate Financing Alternatives

The financing alternatives showed in Figure 3.3. The current condition now is PT. ABC already get advance from Peabody in 2011, but now PT. ABC need more financing immediately. So, the alternatives and the scenarios that will be analyzed in this research are as follow:

1. Fully financed from Trafigura advance payment
This option will refinance part of Peabody facility and cancel the obligation to deliver coal to Peabody. The obligation to deliver the coal is moved to Trafigura.
2. Continue the Peabody facility with additional financing from BNP Paribas
This option will continue PT. ABC obligation to deliver the coal to Peabody, and the additional financing will be financed by BNP Paribas loan.
3. Fully financed by BNP Paribas Senior Loan
This option will refinance part of Peabody facility. PT. ABC will no longer have the obligation to deliver coal to any party.

E. Analysis of Business Solution

In order to align the immediate funding alternative with the medium and long term company strategy which is going publicly traded, every alternative have to be analyzed regarding its impact on company value. The most common method used for valuing the company are DCF (Discounted Cash Flow) and Relative Valuation.

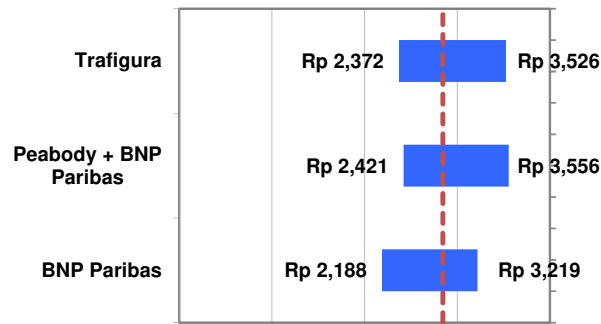


Figure 3. Reference Range (in Billions Rupiah)

After analyzing every alternative and running the simulation PT. ABC is now can look at every alternative clearly, as shown in Table 3.22 and Figure 3.4. Every alternative is summarized as follow:

1. Trafigura Alternative
PT. ABC equity value for this alternative will range from Rp 2,372 Billions to Rp 3,526 Billions.
2. Peabody and BNP Paribas Combined Alternative
PT. ABC equity value for this alternative will range from Rp 2,421 Billions to Rp 3,556 Billions.
3. BNP Paribas Alternative
PT. ABC equity value for this alternative will range from Rp 2,188 Billions to Rp 3,129 Billions.

Based on the company equity value, it can be seen clearly that the BNP Paribas alternative resulted as the lowest from the other two alternatives. So, it can be concluded that the BNP Paribas alternative is not attractive. The other two alternatives are not having much difference. The Peabody and BNP Paribas alternative has slightly higher equity value. Since the difference is not significant, the analysis continues to compare the other additional factor. The next considerable factor is the quantity and quality of the coal to be delivered. The comparisons are as follow:

1. Trafigura
The coal quality is 5,200 GAR with 1% sulfur.
The quantity is 5,000,000 MT to be delivered in 4 years.
2. Peabody
The coal quality is 5,700 GAR with 1.7% sulfur.
The quantity is 850,000 MT to be delivered in 16 months.

Regarding the quality, PT. ABC is now producing 5,900 GAR with 2.2% sulfur. In order to meet the specification of both options, PT. ABC needs to blend the coal with lower calorific and lower sulfur. The lower calorific and lower sulfur coal is derived from other neighboring mine companies. The Trafigura option needs more blend than the Peabody option, because of Peabody's lower calorific value, which means more work needs to be done and more coal need to be bought from neighboring mines. The Trafigura lower sulfur also means more quality control is needed. So, based on quality perspective, the Peabody alternative is more preferable.

The Trafigura 5 millions MT contract quantity is much more than the 850,000 MT Peabody. Because of the Trafigura lower calorific value, it needs to be blended by the coal from neighboring mines with 50:50 ratios. So, from the 5 million MT Trafigura's obligations, the 2.5 million MT is depending on neighboring mines which will increase the risk borne by PT. ABC. Considering the quantity and the risk above, Peabody option is more preferable.

4. Conclusion and Recommendation

Summarizing the analysis above, from three alternatives, one is eliminated which is BNP Paribas alternative, because of the lowest equity value. The Peabody and BNP Paribas combined alternative has slightly more equity value than the Trafigura alternative but not significant. From the quantity and quality factors, the Peabody and BNP Paribas alternative is more preferable than Trafigura alternative.

So, based on the consideration above, the Peabody and BNP Paribas alternative is the most suitable alternative solution for PT. ABC.

In this case, the combination of advance payment and bank loan is the best alternative, but it is not always the best solution. In other cases the solution might be different. It depends on various factors such as interest rate, selling price formula, quantity and quality. Regarding the equity and enterprise value calculation, PT. ABC can continue to use this calculation as consideration for going public in the next few years. The enterprise value can be divided by the amount of total shares to determine the stock price of PT. ABC.

References

- Bank Indonesia. (2012). Informasi Obligasi Negara yang Diperdagangkan di Pasar Sekunder. Retrieved September 30, 2012, from www.bi.go.id:
<http://www.bi.go.id/web/id/Moneter/Obligasi+Negara/>
- Company. (2011). PT. ABC Annual Report 2010. Jakarta.
- Company (2012). PT. ABC Annual Report 2011. Jakarta.
- Damodaran, A. (2006). *Damodaran on Valuation*. New Jersey: John Wiley & Sons, Inc.
- Gitman, L. J. (2009). *Principles of Managerial Finance*. Boston: Pearson Prentice Hall.
- Historical Index Prices of JKSE. Retrieved September 30, 2012, from
<http://finance.yahoo.com/q/hp?s=^JKSE+Historical+Prices>
- Historical Stock Prices of ITMG. Retrieved September 30, 2012, from
<http://finance.yahoo.com/q/hp?s=ITMG.JK+Historical+Prices>
- Historical Stock Price of ADRO. Retrieved September 30, 2012, from
<http://finance.yahoo.com/q/hp?s=ADRO.JK+Historical+Prices>
- Historical Stock Price of BUMI. Retrieved September 30, 2012, from
<http://finance.yahoo.com/q/hp?s=BUMI.JK+Historical+Prices>
- Historical Stock Price of PTBA. Retrieved September 30, 2012, from
<http://finance.yahoo.com/q/hp?s=PTBA.JK+Historical+Prices>
- Norwest Corporation. (2012). *Independent Technical Report of PT ABC*. Salt Lake City.
- Norwest Corporation. (2012). *PT. ABC Coalfield Pre-Feasibility Study*. Salt Lake City.
- Wood Mackenzie. (2012). *Coal Market Report for PT. ABC*. Singapore.