Financial Constraints on Strategy at Missol Petroleum Corporation

A Case Study in Business Strategy and Finance

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Abstract

Corporations repeatedly face financial constraints on their chosen strategies. When this occurs, firms have recourse to four sources of financial flexibility: 1) cut back on capital projects; 2) issue debt at the risk of a credit rating downgrade; 3) issue new equity, risking a depressed stock price and/or dilution; and 4) cut dividend payouts. All four options imply risks and costs for shareholders. Option 1) may impact strategy execution or even change it fundamentally. Option 2) will raise debt costs and reduce future financial flexibility. The others have obvious costs for current shareholders. Sound financial management involves selecting the option which best maximizes long term shareholder value after absorbing these costs.

Project financing can add a fifth option to this list. Certain projects may be well suited to attract non-or very limited recourse funding. Successfully employed, this option can fund projects without impacting the firm's debt rating; such added funding can reduce or eliminate the need for dividend cuts or new equity. Project financing can then seem a preferred, even 'cheap' funding alternative.

However, this allure can cause firms to overestimate project finance's utility. Many projects are not well suited for project financing; their expected cash flows may be too volatile or the project may involve execution or operating risks lenders won't accept. Ignoring such facts can lead to firms to overreach, embedding aggressive project financing assumptions into their financing plans; this project funding may then prove hard to achieve in practice. Firms also may end up conceding far more recourse or partial guarantees in the deals they do consummate. Such terms may ultimately end up impacting debt ratings, frustrating the purpose of the exercise. Because of their capital intensity, energy companies may be especially tempted to 'overreach' on project financing.

This case presents a major energy company struggling with these issues in the course of devising its annual four-year Corporate Plan. Each of the functional Vice-Presidents is citing strategic reasons why its capital program should be fully funded. Yet, internal cash generation looks inadequate to support the consolidated capital budget. Missol Corporation is in the financing 'box' described in the first paragraph above. How much can project financing help? Which projects/programs are legitimate candidates to use this financing tool? How much then remains to be financed and what other option(s) should management employ?

This case is historically grounded in a major petroleum company that struggled with these issues in the mid-1990's. Ultimately it failed to find an adequate solution. After attempting to buy two other firms with stronger balance sheets, Missol was acquired by an industry leader several years later.