Terrasia Aromatics Company (A)

A Case Study in Project Financing to Preserve Corporate Debt Capacity

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Abstract

Project Financing is employed by sponsors for various reasons that relate to capital restrictions. In some cases, sponsor simply lack capital. In others they choose to ration capital in order to multiply the number of projects they can commercialize from a finite pool of equity funds; sponsors may also ration funds to limit their exposure to commercial or political risks.

Another variation of this 'capital rationing' use involves firms concerned with protecting their corporate financing capacity. This may occur when a firm's debt rating faces a risk of being downgraded. The firm may then turn to project financing in order to finance marginal projects without impacting to its consolidated balance sheet and financial ratios.

This case explores the viability of this 'debt capacity preservation' use. It involves a joint venture that developed an Aromatics plant in S.E. Asia during the mid-1990's. Both partners were rated AAA, but one was concerned that its debt rating was exposed to downgrade. This partner made project financing the venture a 'non-negotiable' condition for moving forward. The financially stronger partner resisted, arguing that this demand imposed unnecessary financing costs, hurting the stronger partner's return. Venture negotiations stalemated, threatening project timetable and economics.

Specific issues raised by the case include the viability of 'defending a corporate debt rating' when the project financing in question contains elements of 'limited recourse.' How should a sponsor pursuing this strategy measure the cost of giving limited recourse against whatever benefits it derives from 'insulating its balance sheet.' Another issue concerns the quantification and handling of 'financing costs imposed on a partner.' How should the partner forced to do more expensive project financing measure its economic debit? Should this cost be factored into project economics? Is it reasonable for the 'imposing partner' to compensate for these costs and if so, how?

All of these issues potentially feed back into both sponsors' project economics and their willingness to proceed with the venture. Greater clarity on the economic tradeoffs should facilitate negotiations and enable a resolution of venture financing strategy.