

Midland Energy Resources, Inc.

Brief Case 4129

**Midland Energy Resources, Inc.: Cost of Capital
by Harvard Business School**

2007

ANNUAL COST OF CAPITAL & ANALYSIS



Shokolatte Tachikawa

FIN458: Prof. KhasadYahu Zarbabal
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Case Abstract

The senior vice president of project finance for a global oil and gas company must determine the weighted average cost of capital for the company as a whole and each of its divisions as part of the annual capital budgeting process. The case uses comparable companies to estimate asset betas for each operating division, and employs the Capital Asset Pricing Model to determine the cost of equity. Students are required to un-lever and re-lever betas and, choose an appropriate risk-free rate, and compute costs of debt and equity.

Cost of Capital Analysis @ Midland

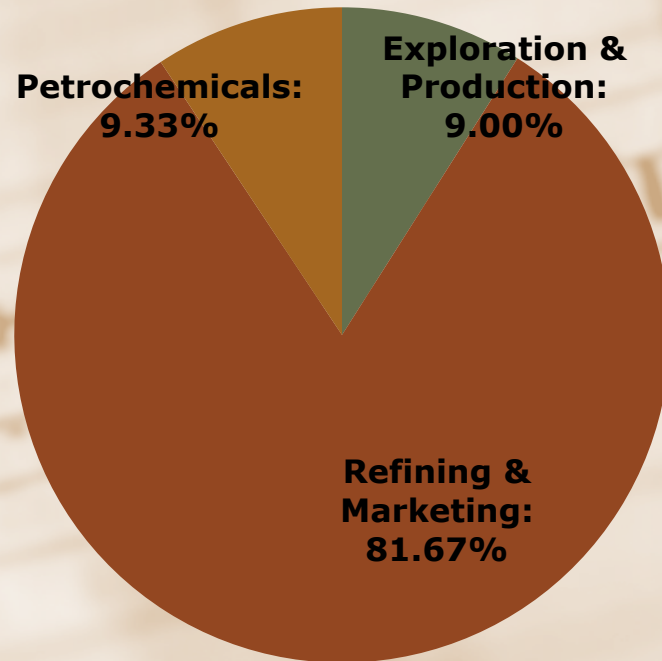
- **Asset Appraisals for both Capital Budgeting and Financial Accounting**
- **Performance Assessments**
- **M&A Proposals**
- **Stock Repurchase Decisions**



Division Level

Corporate Level

Midland Business Segments and Operating Revenue 2006

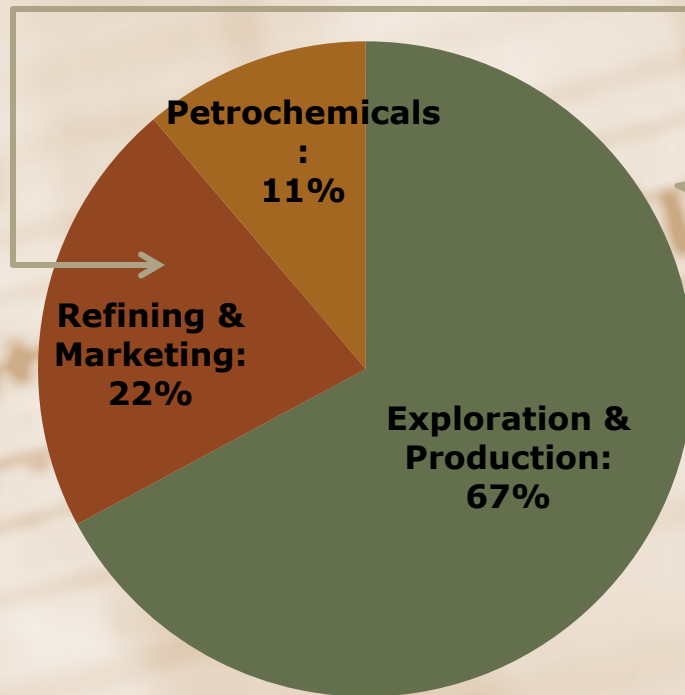


Incorporated 120+ years

80,000 employees

<u>2006</u>	<u>Operating Revenue</u>
Exploration & Production	22,357
Refining & Marketing	202,971
Petrochemicals	<u>23,189</u>
	\$248,518M

After-Tax Earnings/Net Income



**R&M's Profit Margin
is Relatively **LOW****

<u>2006 After-Tax Earnings</u>	
Exploration & Production	12,556
Refining & Marketing	4,047
Petrochemicals	<u>2,097</u>
	\$18,700M



Divisional Operations

1) R&M

2) E&P

3) Petrochemicals

R&M

Refining and Marketing

- Largest segment (rev. \$202,971M[2006])

- 40 Refineries Globally
- Distill 5.0M barrels/day
but

Highly Commoditized & Stiff Competition

$$\text{Profit Margin} = \frac{4,047}{202,971} = \mathbf{1.99\%}$$

Slight Decrease
(1.8%↓) in
2005

Declining
over 20
years

E&P **Exploration**, Development, and **Production**

- Most profitable and highest net margin in industry

$$\text{Profit Margin} = \frac{12,556}{22,357} = \mathbf{56.16\%}$$

- Extracted 2.1M barrels/day (oil)
7.28B ft³/day (natural gas)

**6.3%
Increase ↗ in
Production
over
2005**

**Slightly (<1%)
Increased ↗ in
2005**

Petrochemicals

- Smallest but Substantial

- 25 manufacturing facilities
- 5 research centers

In 8
Countries

Polyethylene, Polypropylene, Styrene, Polystyrene,
Olefins, 1-Hexene, Aromatics, Fuel & Lubricant
Additives

$$\text{Profit Margin} = \frac{2,097}{23,189} = \mathbf{9.04\%}$$

Financial Strategy

- 1) Overseas Growth
- 2) Value-creating Investments
- 3) Optimal Capital Structure
- 4) Stock Repurchases

And also by;

E&P* *R&M* *Petrochemicals

Overseas Growth


- Overseas investments are the main engine of growth
- ML usually invests in foreign government or local business as a partner
- Management fee from project
- 50+% equity interest + preferred return from foreign partner
- 2006 earnings from equity partners: \$4.75B
 - of which 77% (\$3,658M) is from non-US investment

Value-Creating Investments

- DCF to evaluate prospective investments
- Future equity CF for interests in overseas projects and discounted at a K_E rate
 - WACC
- 2 measurements:
 1. Performance against plan over 1-, 3-, and 5-year periods, and
 2. EVA (Economic Value Added)
$$= \text{Debt-free CF} - r_{WACC} * \text{Invested Capital}$$

=NOPAT
=EBIT(1-t)

Optimal Capital Structure

- Long-lived productive refining facilities and energy reserves are large part of capital structure
- Energy Price levels are correlated with Δ ML Stock Price
 - **2007 remarks historic high in both**
 - ML Borrowing Capacity  (additional profit)
- In-house Traders that manage currency, interest rate, and commodity risks

Stock Repurchases


- Whenever attractive opportunities arise
- Intrinsic Value

$$= \frac{\text{Fundamental Value} - \text{Market Value of Debt}}{\text{\# of Shares outstanding}}$$

- No large repurchases since 2002, no plans

E&P

- Oil prices are at historic highs in early 2007 → continued heavy investment in;
 - *acquisitions of promising properties,
 - *development of undeveloped reserves
 - *expanding production



**Sophisticated
extraction
methods**

- Capital spending is expected to **exceed** \$8B in 2007 and 2008

R&M

- Capital spending would remain stable
- Long-term global shortage of refining capacity would eventually spur investment??
- Technology advancement in producing 120K barrels of base-stock lubricants/day
→made ML a market leader?

Historical low
margin
→ **Difficulties in
expansion approval
process**

Petrochemicals

- Capital spending is expected to **grow** as the facilities are in transition period from old to new
- New investment would be undertaken by joint ventures outside US

Capital Structure and Cost of Capital Approach

- β_L to β_{UL}
- CAPM
- Cost of Debt (K_D)
- WACC

WACC

$$= W_E * K_E + W_D * K_D (1 - t)$$

Income
Statement

$= 1 - W_D$

CAPM

Table 1

= US
Treasury +
Spread

Tax Rate

2006 Tax Rate from Income Statement

= Taxes / Income before Taxes

= 11,747 / 30,447 = **39%**

Operating Results:

Operating Revenues

Plus: Other Income

Total Revenue & Other Income

Less: Crude Oil & Product Purchases

Less: Production & Manufacturing

Less: Selling, General & Administrative

Less: Depreciation & Depletion

Less: Exploration Expense

Less: Sales Based Taxes

Less: Other Taxes & Duties

Operating Income

Less: Interest Expense

Less: Other Non-Operating Expenses

Income Before Taxes

Less: Taxes

Net Income

2006

248,518

3,524

252,042

124,131

20,079

9,706

7,763

803

20,659

26,658

42,243

11,081

715

30,447

11,747

18,701

39% <- Tax Rate

<-After-tax Earnings

Unlever Equity Beta (β_L to β_{UL})

$$= \beta_L * \left[\frac{E}{E+D(1-t)} \right]$$

$$= 1.25 * \left[\frac{E}{D(1-t)} \right]$$

$$= 1.25 * \left[\frac{134,114}{134,114 + 79,508(1-.39)} \right]$$

$$= 1.25 * .73$$

$$= .92$$

$$= \beta_{UL}$$

	Equity Market Value	Net Debt	Equity Beta
Midland Energy Resources	134,114	79,508	1.25

Relever β for Each Segments (β_{UL} to $(R)\beta_L$)

$$= \beta_{UL} * \left[\frac{E+D(1-t)}{E} \right]$$

$(R)\beta_L$ for **E&P**

$$=.92 * \left[\frac{54+46(1-.39)}{54} \right] = \mathbf{1.23}$$

R&M

$$=.92 * \left[\frac{69+31(1-.39)}{69} \right] = \mathbf{1.08}$$

Petrochemicals

$$=.92 * \left[\frac{60+40(1-.39)}{60} \right] = \mathbf{1.16}$$

<u>Business Segment:</u>	Debt/ D+E
Consolidated	42.2%
Exploration & Production	46.0%
Refining & Marketing	31.0%
Petrochemicals	40.0%

CAPM for Cost of Equity

In 2006 Midland used an equity market risk premium of 5.0%,

$$K_E = r_f + (R)\beta_L * \text{Risk Premium}$$

E&P

$$= 4.66\% + 1.23 * 5\% = 10.79\%$$

R&M

$$= 4.98\% + 1.08 * 5\% = 10.39\%$$

Petrochemicals

$$= 4.54\% + 1.16 * 5\% = 10.34\%$$

<u>Maturity:</u>	<u>Rate:</u>
1-Year	4.54%
10-Year	4.66%
30-Year	4.98%

Cost of Debt

$$K_D = \text{US Treasury} + \text{Spread}$$

<u>Business Segment:</u>	Spread		*YTM		Cost of Debt
Consolidated	1.62%				
E&P	1.60%	+	4.66%	=	6.26%
R&M	1.80%	+	4.98%	=	6.78%
Petrochemicals	1.35%	+	4.54%	=	5.89%

**This is my
alternate
estimate!**

<u>Maturity:</u>	<u>Rate:</u>
1-Year	4.54%
10-Year	4.66%
30-Year	4.98%

WACCs by Divisions

$$=W_E * K_E + W_D * K_D(1-t)$$

E&P

$$=54\% * .1079 + 46\% * .0626(1-.39) = \mathbf{7.58\%}$$

R&M

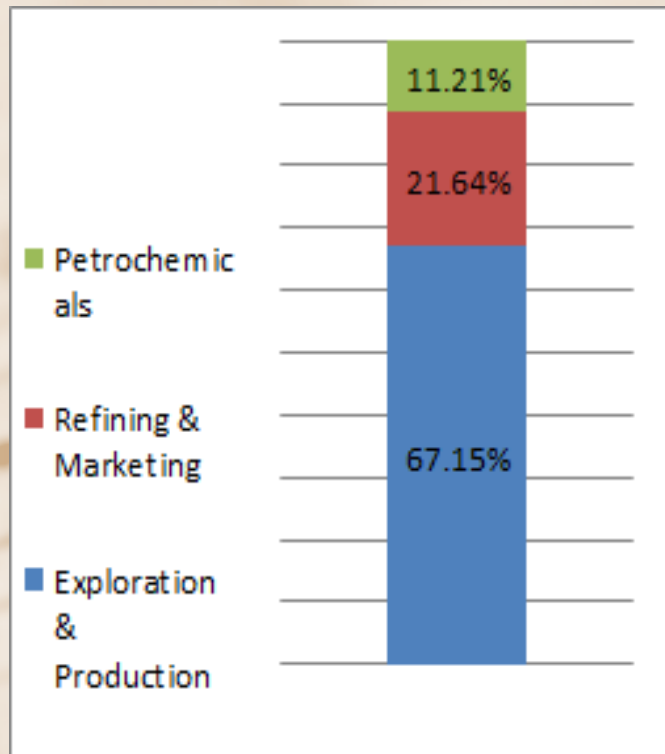
$$=69\% * .1039 + 31\% * .0678(1-.39) = \mathbf{8.45\%}$$

Petrochemicals

$$=60\% * .1034 + 40\% * .0589(1-.39) = \mathbf{7.64\%}$$

cf. Consolidated WACC for Midland

Weighting by Earnings



$$W_{E\&P} * WACC_{E\&P} \\ = 67.15\% * .0758 = \mathbf{5.09\%}$$

$$W_{R\&M} * WACC_{R\&M} \\ = 21.64\% * .0854 = \mathbf{1.83\%}$$

$$W_{PChem} * WACC_{PChem} \\ = 11.21\% * .0764 = \mathbf{\underline{0.86\%}}$$

=>7.78%

*Similar business holdings demonstrate WACC of 9.5% to 16%

Analysis

- **Each division operates in different industry and has different credit ratings**
 - **WACCs differ significantly for each division**
- **Midland should not use a single hurdle rate as a whole to evaluate the opportunity**

Analysis

- **Using different measures for each division (i.e., yields to maturity rate) made it reasonably approximated**
- **The tax rate and risk premium remain constant the entire time which can be applied to the entire corporate value**
- **Overall, the calculated WACC (for each division or even the consolidated) are all lower than industry average, and the estimate from this method can be considered equitable**

References

Case: <https://www.hbs.edu/faculty/Pages/item.aspx?num=41848>

*<https://finbox.com/LSE:OGDC/models/wacc>

*<https://www.gurufocus.com/term/wacc/ODVCI/Weighted%252BAverage%252BCost%252BOf%252BCapital%252B%252528WACC%252529/Oil+%2526+Gas+Development+Co+Ltd>