EFFECT OF GEARING ON SHAREHOLDERS WEALTH
A CASE STUDY OF PEUGEOT AUTOMOBILE NIGERIA LTD.

BY

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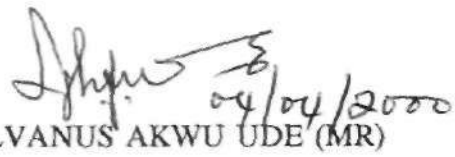
A PROJECT PRESENTED TO THE

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AWARD OF MASTER OF BUSINESS ADMINISTRATION (MBA) DEGREE

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DECLARATION

I declare that no part of this work has been submitted for an award of a Degree or Diploma of any University.



04/04/2000

SYLVANUS AKWU UDE (MR)

DEDICATION

This work is dedicated to the memories of my late Father, Mother and uncle Ndukwe Nkama who died in 1982, 1991, and 1994 respectively.

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CERTIFICATION

This project Report, Thesis, Dissertation, entitled EFFECT OF GEARING ON SHAREHOLDERS WEALTH: A case study of Peugeot Automobile Nigeria Limited by Sylvanus Akwu Ude, meets the regulations governing the award of the Degree of Master of Business Administration of Ahmadu Bellow University (ABU) and is approved for its contribution to knowledge and literary presentation.

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ACKNOWLEDGEMENT

I most humbly thank my Lord and God for His grace which saw me through the entire course. May His name be highly exalted.

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SYLVANUS A. UDE

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ABSTRACT

Peugeot Automobile Nigeria Limited (PAN) as associate (Company to Automobiles Peugeot (AP) France is 60% Nigerian and 40% French. Very little capital is invested while the large chunk of the "Working Capital" is borrowed from local banks and finance houses. The Annual Report and Accounts for five years (1992 - 1996) was analysed and it was discovered that PAN spends between 249% and 1485% of its fully paid Capital in servicing the loan finances.

An all equity structure was simulated and analysed alongside the existing highly geared structure. The results obtained show that three out of the five years (60%) favoured the all equity structure in the Earnings per share while four out of the five years (80%) favoured the all equity structure in the profitability ratios. All show that PAN is not earr ing enough returns on its assets at the moment.

The measures of short-term solvency show that PAN's short-term asset holdings cannot sufficiently repay short-term liabilities if the latter were forced to be paid all at once.

Concerning the ways of minimizing interest payments, ittention was drawn on the difference between nominal and effective rates of interest with an emphasis on the need for the recalculation of bank charges as enormous amounts have teen recovered in the process. Without such recoveries, the interest expenditure posted in PAN records could have been much higher.

It is observed that one of the ways of controlling profitability is to increase sales volumes. Under the present economic climate in Nigeria, PAN which is producing 24 to 26 cars a day (10% of installed capacity) cannot easily increase sales volumes because the car prices are very high.

Some recommendations were made on the possible ways of improving sales volumes in the present economic circumstances.

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CHAPTER ONE

INTRODUCTION

1.1 Introduction

Shortage of funds for working capital has been possibly the biggest cause of business failures in recent years. New ventures fail for lack of continuing finance: others are forever postponed. However, these are minor disappointments compared to the total collapse of major companies which has been brought about by the drying up of funds required for day-to-day running of the enterprise[1]

In any company, the overriding objective of the directors, in so far as they act rationally and in the interest of their ultimate 'masters' is to maximize the wealth of the equity shareholders within the constraints of law, morality and public policy, and the said shareholders.

Maximization of equity shareholders fund requires the achievement of two sub-objectives:-

(1) The obtaining of maximum rate of return on the funds entrusted to the company

(2) The raising of these funds at minimum costs relative to existing equity shareholders' interests. The first is the province of management accounting in the spare of capital budgeting and project appraisal while the second is the principal concern of financial management in relation to the design of the company's initial capital structure and its modification over-time[2].

Gearing (Leverage in America) is the term used to refer to the levels of debts which a company employs in relation to its equity capital. It has both advantages and disadvantages, depending upon the relationship between company profitability and the interest payable on debt[3] More will be said about gearing in chapter two.

Borrowed funds do not come easily as adequate securities must be provided to act as collateral to the providers of funds in case of ultimate non-payments. Also while they last, borrowed funds attract heavy interests. Thus the financing or capital structure decision is a significant managerial decision as it influences the shareholders' return and risk.

1.2 Statement of the problem

Peugeot Automobile Nigeria Limited (PAN) has an authorised, issued and fully paid ₦105 million capital made up of 52,500,000 ordinary share of ₦2.00 each. Up to 1992 this was ₦15 million made up of 7,500,000 ordinary shares of ₦2.00 each. Table one shows PAN's earnings before interest and taxes for five years.

Table 1: PAN's Ebit 1992 - 1996

1992 ₦'000	1993 ₦'000	1994 ₦'000	1995 ₦'000	1996 ₦'000
258838	257507	398963	486214	461327

Source: PAN Annual Report and Accounts.

At the same period, Loans, Bankers Acceptances and Bank Overdrafts stood as shown in Table 2.

Table 2: Borrowed Funds for PAN operations

	1992 ₦'000	1993 ₦'000	1994 ₦'000	1995 ₦'000	1996 ₦'000
Debenture Stock	2862	94	94	94	58
Bankers Accept. Unsecured	398200	334800	433000	970995	877683
Bank Overdrafts (Secured)	137533	127571	171395	96764	113161
Short-term Loans Secured	3917	4242	4242	4992	2742
Total	542512	466707	608731	1072845	993644

Source: PAN Annual Report and Accounts

Table 3: Interest paid to providers of fund before taxation

YEAR	AMOUNT	% VALUE ADDED	% SHARE CAPITAL	% TOTAL ASSET
	₦'000	₦'000	₦'000	₦'000
1992	222758	51	1485	58
1993	244514	59	233	67
1994	365189	60	348	102
1995	459831	58	438	128
1996	261748	34	249	17

Source: PAN Annual Report and Accounts

The analysis in Table 3 shows that PAN spends a greater part of its "Value Added" in paying interests to providers of loan finances. These payments represent between 233% and 1.485% of its share capital values for the same period or 17% to 128% of the total asset values.

Such huge expenditure in interest payment is more than the capital employed of many public limited liability companies in Nigeria. The apparent conclusion is that an enterprise spending so much on interest is over-trading. Does the situation augur well for the shareholders? What, if they could increase the capital and thus reduce such loans that attract so much interests?

1.3 Objectives of the Study

The study is undertaken in partial fulfillment of the requirements for the award of Master of Business Administration (MBA) Degree. From the problem analysis, the researcher would investigate whether or not:-

(a) Earnings Per Share and Shareholders' Fund would not rise if PAN increases its equity capital over and above its interest earning loan finances.

(b) If anything could be done to reduce the amount of interest payment under the existing structure.

(c) If PAN's profits over the years has been commensurate with its total assets.

(d) How easily PAN could pay its current debts.

1.4 **Significance of the Study**

Apart from the objective of providing stated services to the community, a business enterprise is expected to make profits in order to stay afloat. Shareholders demands are expressed in dividend income or capital growth. They thus require that profits be sufficient to pay satisfactory dividends and that ploughed-back profits cover internal investment opportunities for the future capital growth. Certain shareholders wish to maximize dividend payments, e.g persons living on investment income and company controllers who as "dividend strippers" exploit their position for maximum short-term gains. Opinions differ as to whether share-prices are an increasing function of retained earnings or dividends. Higher dividends however improve share values on the grounds that capital gains are less certain and more risky than immediate dividend expectations. Therefore, a company pursuing a policy of earning retention commands a lower P/E ratio than one that maximizes dividends. Friend and Purckett, on the other hand, argued that the value of ploughed-back profit was more significant. The controversy continues. However, there is one situation when earnings retention contribute to capital gains. The newly-established company at the innovate and subsequent growth stage of the life cycle of the firm is likely to be permanently short of funds. Shareholders in this situation are usually prepared to discount present income and reinvest earnings for the substantial gains that are anticipated in the subsequent maturity stage of the firm's life cycle. Thus, at this point in time, the prerequisite for success is additional funds which may be raised either externally or internally: however, additional funds raised outside will dilute the equity, so that shareholders must share the anticipated gains: hence their preference for self-financing.[4]

From the foregoing, it is evident that dividend income, capital growth, ploughed-back profit or retained earnings and share values help both the existing shareholders and the investing public perceive how a business enterprise performs. Since these are first and foremost, the function of profit and then the management policies, this researcher believes that the investigation of the Financial Structure which maximizes profit is worthwhile.

1.5 Scope of the Study

The study is carried out at PAN Head Office only where the main actors in the preparation of the Accounts could be consulted for an explanation to certain components of the Accounts. The Annual Report and Accounts is considered enough document for the analysis required.

1.6 Limitations of the Study

One of the biggest limitations to the study is time. It is very difficult to combine full-time employment with rigorous academic exercise. Another limiting factor is the scarcity of textbooks on Finance in the public libraries. Again the researcher would have loved to investigate how other companies in the motor industry fund their operations generally in Nigeria but time and financial resources make this impossible.

1.7 Definition of terms

Bank Overdraft: This is the amount which the bank permits a company or an individual to withdraw above its/his credit balance. Such amount overdrawn attracts an interest at an approved rate. It is cheaper than an outright loan from the bank because once a loan is negotiated interest is charged on the amount whether the loan was utilized or not and whether there were moments the balance was credit in the current account.

Bankers Acceptance: These are drafts that are accepted by banks and they are used in financing foreign and domestic trade.

Capital Budgeting: Capital budgeting is a many sided activity that includes searching for new and more profitable investment proposals, investigating engineering and marketing considerations to predict the consequences of accepting each investment, and making economic analysis to determine the profit potential of each investment proposal.[5]

Capital growth: The rising in value and/or number of shareholdings through the issue of bonus shares and share price appreciation in the stock market.

Capital Structure: The interrelationship between long-term sources of financing represented by long-term debt, preference share capital and net worth (ordinary share capital plus reserves and surplus).[6]

Debenture Stock: This is a form of borrowing by a company from the general public, acknowledged by the company in form of a certificate.

Dividend income: Total income earned from dividends.

Earnings Per Share: The total earnings, net of tax attributable to equity divided by the number of shares.

EBIT: Earnings before interest and taxes.

Equity Shareholders: These are the ordinary shareholders of the company. They are the members of the company and are the real proprietors of it. They share all revenue and capital profit after any preferential rights have been satisfied.

Financial Structure: Refers to the way the firm's assets are financed. Capital structure is the permanent financing of the firm represented primarily by long-term debt, preferred stock and common equity but excluding all short-term credit. Thus a firm's capital structure is only part of its financial structure.[7]

Gearing: Gearing is the relationship between the loan capital, preference capital and ordinary capital of a business. A high-geared company is one where the prior charges, i.e. loan and preference capital, are high in relation to the ordinary capital. The reverse is described as low-geared.

Over-trading: Engaging in business activities that requires more fund than the working capital employed.

Plough-back profit (Retained earnings): Undistributed earnings.

Price Earning Ratio (P/E): The ratio of market price per share to earnings per share.

Rate of Return: Represents the highest rate of interest an investor could afford to pay without losing money, if all the funds to finance the investment were borrowed and the loan (principal and accrued interest) was repaid by application of the cash proceeds from the investments as they were earned.[8]

Secured and unsecured loan: A loan where the principal and possibly interest as well is secured on some asset of the borrowing organization such that if the borrower defaults the lender may seize the asset and sell it to repay the amount owing. Unsecured loans do not fall back on any asset in case of default in payment.

Shareholders Fund: This is the total of issued ordinary share capital, share premium, general reserves and retained earnings.

Shareholders Return and Risk: Shareholders expected profit and the variability of the expected profit.

Share Prices: The market price of shares in the stock market.

Total Assets: The sum of fixed assets (Land, machinery and Buildings) and current assets (cash, debtors and stock).

Value Added: Valued Added is the difference between the value of a firm's product and the cost of intermediate products bought from outside suppliers.[9]

Working Capital: Working capital is the net balance of current operating assets or the surplus of current assets over current liabilities.

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CHAPTER TWO

LITERATURE REVIEW

2.1 PAN Corporate Structure and Business

The Company was incorporated as a limited liability Company on December 15th, 1972 under the Companies Act 1968. It was formed principally for the Assembling of motor vehicles under an agreement between the Federal Government of Nigeria and Automobiles Peugeot France. The issued Share Capital is held as follows[1]:-

1.	Federal Government of Nigeria	35%
2.	Automobiles Peugeot, France	40%
3.	Kaduna Industrial and Finance Company Ltd	4.7%
4.	Katsina State Development Company Ltd	5.3%
5.	Nigeria Industrial Development Bank Ltd	5%
6.	SCOA Nigeria Plc	5%
7.	UTC Nigeria Plc	5%

At inception, the Company's Share Capital was ₦15 million. This was however increased to ₦105 million in 1993 following the injection of ₦90 million through bonus shares[2].

PAN is currently under-capitalized and according to the visiting Minister of Industries it requires Capital injection of about ₦3 billion while ₦1.4 billion of this amount is required as working capital. The Minister continued: The Federal Government is willing to provide its own share of the required funds provided Automobiles Peugeot (AP) France is favourably disposed to meeting its own financial obligation in line with the equity structure, assuring the Technical partners that they have nothing to worry about as the new government policy allows easy, unhindered and timely repatriation of capital and dividend when declared, through the purchase of foreign exchange at the

Autonomous Foreign Exchange Market (AFEM).[3]

It is evident from the above that PAN is an associated Company to AP, France - a multinational Company. All multinational companies consider tradeoffs between debt and equity. The main issue is the cost of debt versus equity. A number of studies in international finance[4] have indicated that firms are generally not making decisions on the basis of the cost of capital. Other factors, such as political risks, currency stability, foreign exchange fluctuations and exposure risks, control of remittance and repatriation of capital, tax structure and expropriation risks play important roles in financial decision making. They thus prefer to finance their overseas operations through debt rather than through equity. Local borrowing is preferred to foreign borrowing largely because of foreign exchange and political risks.

Debt Equity Ratios

The financial structure norms in terms of debt-equity ratios differ significantly among different nations. Environmental, institutional and governmental regulations seem to play important roles in establishing these norms.

Table 4: Debts ratios in selected industries and Countries 1964 - 1965

COUNTRIES	ALCOHOLIC BEVERAGES	AUTOMOBILES	IRON & STEEL	FOODS	CHEMICALS
France	35.8	36.0	33.7	24.7	34.3
West Germany	59.2	55.1	63.8	42.5	54.8
Italy	64.9	77.3	77.9	66.4	68.2
Japan	60.9	70.3	74.5	78.3	73.2
United Kingdom	43.8	56.5	44.9	47.6	38.7
United States	31.1	39.2	35.8	34.2	43.3

Source: Regents of the University of California drawn from Anant R. Negandhi: International Management P. 488.

Table 5: Debt ratios in selected Industries and Countries, 1979 - 1980

Countries	Alcoholic Beverages	Automobiles	Iron & Steel	Foods	Chemicals
France	56.3	67.3	74.1	77.7	72.1
West Germany	-	57.1	51.6	48.8	56.2
Italy	-	21.7	90.2	83.4	67.7
Japan	-	71.3	87.5	76.3	81.2
United Kingdom	41.9	72.8	50.7	55.3	49.8
United States	51.1	58.0	54.3	55.4	54.7

Source: J.M. Collins and W.S. Sekely "The Relationship of Headquarters, Country and Industry classification to financial structure". Financial Management 12.3 (Autumn 1983): 489 Drawn from Anant R. Negardhi: International Management P.489.

Table 6: Equity Ratios by Country *

COUNTRY	1977	1978
France (21 firms average)	24.99%	26.80%
West Germany (25 firms average)	28.59	28.92
Italy (7 firms average)	22.90	26.31
Japan (103 firms average)	21.77	22.86
United Kingdom (38 firms average)	42.05	41.87
United State (177 firms average)	49.92	49.40

* Wighted averages.
Source: Ministry of International Trade & Industry, Tokyo, Japan: International Companies of Management, 1980 PP 48-87. Taken from Anant R. Negard L. International Management P.490.

The above tables depict an internationally growing trend towards debt financing which reflects desires to hedge against political and foreign exchange risks and to reduce taxes because the interest on loans is deductible in most Countries.

Robbins and Stoubaugh's study of 187 United State multinational companies revealed the following patterns:-

Most foreign subsidiaries are started with a modest sum. After incubation, internal funds flows are the dominant source of funds, and when coupled with local borrowing, leave relatively little need for fresh funds from headquarters.[6]

United State, as well as European and Japanese subsidiaries depend on local borrowing for both short-term and long-term financing. This is done regardless of interest rate differentials. In other words, international corporations' financial practices are less than optimum. As discussed earlier, the main advantages of local borrowing are to:-

1. Secure protection against losses caused by currency devaluation.

2. Reduce the liabilities of the parent company by not consolidating the subsidiaries debt, occurred through local borrowing in the annual report.

3. Meet governmental restrictions on capital inflow and outflow.

4. Foster good relations with local banks and other financial institutions.[7]

From the foregoing, one would doubt the possibility of the French partners readiness to inject more funds in other to increase the working capital of PAN

as is being suggested by the Honourable Minister of Industries.

PAN operates a treasury Department with the representative of AP as the Assistant General Manager. He oversees the sourcing of funds locally in line with the above stipulations.

2.2 **Sources of Funds**

There are three main groupings in the source of funds, namely:

1. **The Permanent Funds**
   - Share Capital
   - Reserves
   - Rights Issue
2. **The Long-term Funds**
   - Loan Capital
   - Debentures
   - Comertible Loan Stock
3. **Short-term Funds**
   - Bank Overdrafts
   - Bankers Acceptances
   - *Commercial papers*
   - **Current Liabilities**
   - Sundry Creditors
   - Taxation
   - Proposed Dividend

The permanent funds represent principally the shareholders funds while the long-term funds represent long-term loan capital. The short-term funds are partly short-term loan capital and partly current liabilities of the Company. The term "permanent" in this context means not repayable during the life of the Company. "Long-term is at least five years from the balance sheet date while

"short-term funds are repayable within five years of the balance sheet date". Current liabilities are specific debt normally repayable in the course of trading.[8]

Shareholders Fund

The Shareholders' funds consist of share capital and reserves. The share capital itself may be preference and ordinary shares. Every company must have an ordinary share capital whereas preference shares are optional ways of raising funds. Technically speaking, both the preference and ordinary shareholders are members of the company and own it together, but in fact, the preference shares have many characteristics of loan capital and the real beneficial owners are the ordinary.

Preference have priority before ordinary in two respects. Firstly, when the Company is still trading in the entitlement to dividend and secondly, when the company goes into liquidation in entitlement to return of capital.[9]

Reserves

Reserves are retained profits. There is however more than one kind of reserve just as there is more than one kind of profit. A revenue profit is one made by the means of the company's normal trading activities, as distinct from capital profit which arises by virtue of the appreciation of the company's fixed assets. For example, If PAN Ltd whose business is to manufacture and sell motor vehicles makes a profit by so doing, that would be a revenue profit. If however, it sold one of its buildings at a price above the value of the building in the Company's books and balance sheet, the excess would be a capital profit.

Revenue Reserve

It has been said earlier that a dividend was distribution of profit. It can now be said that it is a distribution of revenue profit. When a revenue (after tax) is earned, the Revenue Reserve is increased by that amount. If part of the profit is paid as a dividend, the revenue reserve is decreased by that amount. If the

Company suffers a revenue loss, that also reduces the revenue reserves. Therefore, the reserve stands to be increased by a profit, or to be reduced by a loss and by the payment of dividend.

The revenue reserve is the net revenue profit (less losses) retained in the Company at that date. It is the amount that may be distributed as dividend, subject of course to the discretion of directors and the liquidity of the Company, since the dividend is paid cash, cash must be available or obtainable whatever the amount of revenue reserve.

In addition to being allowed to distribute the revenues profits, a company can also distribute capital profits in certain circumstances namely: when the capital profit has been realised, the profit remains after a revaluation of all the company's assets, and such a distribution is permitted by the Company's articles. It is a growing practice in Company account for the capital reserves other than the share premium account, and the revenue reserve to be shown in one figure with a note to the effect that so much of the reserve is a capital reserve which is not available for distribution. The share premium account is shown separately and is not available for the payment of dividend.

This capital profit can arise either by realisation or by revaluation. When a fixed asset is realised, the capital profit is the excess of the cash realised over the book value of the asset disposed of. The profit is determined by reference to the book value and not to the original cost of the assets.

Capitalization of Reserves

A capitalization of reserves is simply a book-keeping operation which involves the issue of new ordinary shares to the existing ordinary shareholders in proportion to their holdings. These new shares are credited as fully paid and the nominal value of shares so issued is taken out of the reserves and

transferred to share capital.

Loan Capital

Apart from the shareholder funds, the other major source of long-term fund is "Loan Capital". The basic categories of loan capital are secured loans and unsecured loans. The term "Debenture" generally signifies secured loan stock. Almost all corporate loan stocks are redeemable.

Debentures

A Company normally issues a loan stock under the term of a trust deed which sets out all the conditions of the loan such as its rate of interest (called its ("coupon") and dates of payment of interest, dates of redemption, a statement as to whether the loan is secured or not, whether the Company is permitted to borrow other loans and so on. A trustee is appointed to administer the trust deed: the trustee may be a person, but is more often an institution such a bank or Insurance company.

Convertible Loan Stock

This is nearly always unsecured loan stock redeemable in (usually) 20 to 25 years but carrying the additional feature that it is convertible at the choice of the stockholder into a certain number of the company's ordinary shares per ₦100 nominal of the loan stock at certain specific future date.

Rights Issue

A rights issue is a financing technique that involves selling common stock in the primary securities market by issuing rights to its existing shareholders the first opportunity to purchase the new shares before offering them to non-shareholders. Within this context a right is an option to buy a specified number

of shares of common stock at a specified price per share, over a fixed time interval. The firms shareholder have the following three options:-

1. To exercise the right which means purchasing the new shares directly from the issuing corporation
2. To sell their rights
3. To hold the rights until they expire.

If the rights are exercised, the offering is fully subscribed and the firm obtains its needed financing. When some rights expire without being exercised, the issuing firms end up with unsold new shares. The firm uses an investment banker as a selling agent to process the rights as they are exercised and to issue the new common shares. This means that the investment banker agrees to purchase at a specified price any shares of common stock that are not bought through the rights offering. Technically speaking, the investment banker "underwrites" the rights issue.

Impact of Rights on Shareholders wealth

A rights offering in and of itself, does not increase shareholders wealth. However, existing shareholders must either exercise their rights or sell them in order to avoid suffering a decrease in market value.[10]

Bank Overdraft

The bank overdraft is familiar to everyone, but there may be one or two points about it which should be elaborated, and particularly the essential difference between an overdraft and a loan. Whereas a loan involve a transfer to current account, an overdraft does not. An overdraft facility allows one overdraw (that is go into debit) up to an agreed limit during a certain period, at the end of which the limit is renegotiated. Without such a facility, one can draw cheques on ones current account until the balance falls to zero. With overdraft facility of say ₦10,000.00 one can draw cheques until the balance falls to

—₦10,000.00 and the cheques will still be honoured.

Interest is not payable on the facility but only on the actual amount overdrawn calculated on a day-to-day basis, and the interest is normally debited to the account each half year in arrears. With a loan one pays interest on the whole amount of the loan irrespective of whether the whole amount of the loan is being utilized all the time or not. Interest is usually charged on the loan half-yearly in arrears if it is a bank loan, but other lenders sometimes add on the interest in advance. Sometimes interest on loans is charged on the reducing balance where it is a condition of the loan that parts of it be repaid at regular intervals. In other cases, interest is charged at a flat rate on the initial amount of the loan.

The question of collateral or security is a matter for the bank manager to decide in the case of both an overdraft and a loan, but the rate of interest will probably be higher where the loan or overdraft is unsecured. One must add however that because of certain malpractice in Nigeria these days, bank managers are not allowed such wide powers beyond certain amounts hence bank management stipulate as a matter of policy how loans and overdraft are given out to customers. For a company a floating charge over its assets may be required by the bank; for an individual, marketable securities (quoted shares) make popular collateral. Life policies are also often acceptable. Sometimes the bank expects a guarantee from someone indemnifying the bank on the borrowing of a company or another individual. The guarantor would be liable in the event of default by the borrower.

Each limited Company is a separate legal entity, so that in a group of

Companies a credit balance of one subsidiary cannot automatically be set off by the bank against the debit balance of a fellow subsidiary. The parent Companies are often required to guarantee the borrowing of a subsidiary. Such a guarantee would appear as a contingent liability in the notes to the balance sheets.

Bankers Acceptance

Bankers acceptances are arrangements for short-term financing which allows a borrower to obtain from a bank only those funds that are actually needed at the time of need. For example, assume that PAN Ltd wishes to buy some raw materials. Before ordering these, the company arranges with its bank to accept drafts drawn against the bank for the goods to be purchased.

The bank issues letters of credit, which indicate that it will accept the drafts. PAN Ltd then sends the letter of credit to the producers of the raw materials, instructing them to send the bills of lading to the bank and to draw on the bank for the purchase price. When the materials arrive, the bank accepts the drafts. In order to obtain the bill of loading, PAN Ltd must sign a note in favour of the bank[11].

Commercial Paper

Commercial paper consists of short-term unsecured promissory notes issued by finance companies and certain industrial concerns. Rates on commercial paper are somewhat higher than rates on Treasury bills of the same maturity. Usually commercial paper is sold on a discount basis and maturities generally range from 30 to 270 days. Most papers are held to maturity, for there is essentially no secondary market. Commercial paper is sold only in fairly large denomination usually at least ₦25,000.00[12]. Usually on maturity, the loan could be renegotiated and "rolled over". In that case the Company issues a cheque for the cost up-front.

Sundry Creditors

These consist of Trade Creditors and accrued charges. Trade Creditors are amounts owing at the date of the balance sheet in respect of good received from suppliers prior to that date. Accrued charges are sums provided in respect of services consumed up to the balance date which are usually charged for a period extending beyond that date.

The significance of the sum owing to trade creditors is not in the absolute amount, since that would be largely determined by the volume of business, but by the length of time which the Company takes to pay its debts.

Trade creditors is a very important item because it is virtually the only major and variable source of credit which can be cost free. Loan capital and bank borrowing cost interest and taxation is usually payable on a certain date and the Company has little scope for extending it.

PAN's treasury department prepares on weekly basis what is called "PAN Total Commitment". These consist of Commercial Papers, Bankers Acceptances, Loans from Banks, amounts owing to Sundry Creditors for supplies to the Company, Prepayments from PAN Distributors, utilized overdraft facilities and the Value Added Tax. This amount runs into several millions of Naira weekly.

2.3 GEARING AND CAPITAL STRUCTURE

The gearing ratio or coefficient indicates the relative proportions of the types of capital employed in a Company. The gearing ratio can be measured by the ratio.

$$\frac{\text{Borrowed Funds}}{\text{Ordinary Shareholders Funds}}$$

factors:

(a) The borrowing powers in a Company's articles of association

(b) The existence of charges on the Companys' assets.

(c) The attitude of shareholders towards control. They may resist attempt to diffuse their equity holding and prefer "debt" capital as a source of new finance.

(d) The relative costs of raising debt and share Capital.

(e) The level of anticipated profits in relation to the fixed interest charges on debt capital.[13]

Capital Structure is the permanent financing of the firm represented primarily by long-term debt, preferred stock, and common equity, but excluding all short-term credit. Thus, a firms capital structure is only a part of its financial structure. Common equity includes common stock, capital surplus and accumulated retained earnings.[14]

Borrowing

Some issues are associated with loan finance. One of the major issues is the burden of interest which heavy borrowing incur. In theory, no money will be borrowed unless it earns more for the Company than its costs. There are some problems here. Firstly, the calculations must be made on expectations which may be wrong, either through error or a change in the basic circumstances. Companies do not always make the profits they forecast. This is really a question of acceptable risks, which must be taken into account when the plan is prepared[15].

Secondly, to maintain a positive cash flow, the retained profits on the projects for which finance is required must be greater than the interest.

Thirdly, a project may be a good investment, but may not breakeven for several years. During this early period, the interest burden along with other unrecovered costs must be paid from elsewhere.

Cost is as important in considering borrowed finance as it is with equity.

One overriding strategic consideration is that the Company should try to select its sources in a way that leaves it the utmost flexibility. This means all other things being equal, that unsecured loans are preferable to secured loans, or that equity might be better than a loan which puts a charge over all the Companys' assets.

Effects of gearing on the Shareholders Earnings

The role of gearing in magnifying the earnings of the shareholders is based on the assumption that the fixed charges funds can be obtained at a lower cost than the Company's rate of return on its assets. The earnings per share or the rate of return on equity will fall if the Company obtains the fixed charges funds at a cost higher than the rate of return on Company's assets.

The earnings per share (EPS) and the rate of return on equity are important figures for analysing the impact of gearing. The effect of gearing may be favorable or unfavourable. Favourable gearing occurs when the earnings per share increase due to the use of debt in the capital structure. unfavourable gearing occurs when the EPS decrease because of debt in the capital structure[16].

Advantages of gearing

(a) When profit are high in relation to total fixed interest charges, the ordinary shareholders in a highly-geared company benefit immediately from additional dividends, or in future from the earnings generated by its retained profit.

(b) It enables a company to increase its capital without dilution of equity and shareholders' control[17].

Disadvantages of gearing

(a) High gearing is disadvantageous to equity holders when profit are falling since they receive disproportionately less by way of dividends.

(b) The company is committed to long-term fixed-interest payment which could cause cash flow problems.

(c) Charges may be placed on company assets.

(d) Once assets are pledged, further gearing may be accomplished only by offering higher yields to lenders to compensate for lack of security.

(e) Gearing demands that management produce sufficient profits to pay interests and dividends and meanwhile establish a sinking fund for the redemption of debentures,

(f) Companies whose incomes fluctuate (perhaps their products are elastic in demand) will find it difficult to maintain satisfactory dividend rate and share prices.

(g) Investors will be reluctant to subscribe new capital.

The choice of finance

A company in need of additional finance has a wide choice, its final option being influenced by the following consideration:

(a) The relative cost of borrowing by different method. This is known as the trade off with costs.[18]

(i) The cost of capital is the interest which has to be offered on debentures, the dividends on preference shares and yields on ordinary shares to attract investors capital. Obviously the opportunity cost of capital is relevant, but in addition it is influenced by the investors attitude towards risk, reward and control offered by various securities. For instance, lenders will demand higher rewards on ordinary shares and unsecured loan stock than on preference shares or secured debentures, to compensate for the higher risks. But they will demand less if they confer control with its attendant advantages.

(ii) The administrative costs involved in raising the capital.

(b) **The term of the Finance:** Projects which mean that expenditure will not be recouped in the short-term suggest long-term finance which is generally more expensive. However, in times of high interest rates, a company should consider financing a long-term project by redeemable securities and by short-term borrowing when there is a good chance that it can be re-financed later when rates are lower.

(c) **The effect of taxation:** Loan interest is allowable against profits (unlike dividends) in the assessment of corporation tax.

(d) The value and nature of corporate assets available as security.

(e) The nature of conditions imposed by lenders on a company freedom of action, e.g. restriction on future borrowing ability if assets are pledged.

(f) The Company's ability to earn a sufficient cash flow to pay fixed charges and repay loans e.g. redeemable debentures.

(g) The Company's existing structure and the effect of new borrowing on capital and vote-gearing.

(h) Market Conditions, e.g. a severe "credit squeeze" may make it impossible to obtain short-term bank finance, or the capital market may already be "saturated" with new issues.

2.4 Dividend Policy

There are three major decisions taken in finance which have influence on the value of the firm namely: the investment decision, financing decision and the dividend decision. These decisions are interdependent in many ways. The Capital structure or the financing decision of the firm determines the cost of capital. The cost of capital determines the number of acceptable projects and these acceptable projects determine the value of the firm and the future dividends.

Determinants of Dividend Policy

The dividend policy of the firm defines how the earnings of the firm are distributed. These earnings can be reinvested to boost future earnings or paid out in dividends to provide current income for shareholders. A lot of factors however combine to determine the distribution of the firm's earnings between retained earnings and dividends[19].

1. **Legal Constraints** Most Countries regulate the dividend payments that firms can make. Such regulations may include a restriction on the firm to pay dividend out of its capital account.

2. Tax Constraints Dividend payments are a taxable income. If they are not paid to shareholders they will not be taxed, unless a shareholder sells his share to realize a Capital gain. Generally, the tax on Capital gain is less than that on dividend.

3. Existence of Restrictive Contract Mostly for long-term creditors, e.g. banks.

4. Liquidity Constraints Even though a firm is making profits, it is not likely to be liquid and if a firm is not liquid it may not pay dividends, especially when it is the policy of the firm not to borrow to pay dividend.

5. Access to Capital Market If a firm has access to many sources of finance then it can afford to pay dividend with the aim that it could borrow to finance its projects from these sources. But if otherwise, then the firm may decide not to pay dividend and use its currently available fund for further investment.

6. Growth Opportunity If the firm is a growing one, there is the likelihood that it will retain a major part of its earnings to finance the growth.

7. Shareholders Preferences Even though shareholders preferences cannot be aggregated they can still in a way influence the dividend policy of the firm. In a closely held firm (a firm with a few shareholders) if the majority of these owners are in a higher tax bracket, they will prefer the retention of a significant portion of earnings so as to earn capital gain.

8. Protection against a dilution If a firm pays out all its earnings in dividends this means it has to either issue new shares or raise more debts to finance projects. But if it does not want to dilute the ownership of the firm then a better way out is to depend on retained earnings.

Types of Dividend Policy

There are several dividend strategies adopted by firms and they include[20]:-

1. Residual Policy This states that dividend payments will vary from year to year depending on the available investment opportunities. A firm can retain a greater portion of its earnings in a year when funds are needed to finance investments. This residual theory however, does not say that dividend should be cut rather the firm can prevent a cut in dividend by raising its level of coverage. In future when funds flow in, the firm can bring its debt-equity ratio back to its normal level. This theory suggests that "growth" firms will normally have lower dividend pay out ratio than other non-growth (matured) firms.

2. Stable Dividend Policy This theory suggests that dividend be made stable over periods of time. It can however be reviewed upwards if management is of the opinion that the earnings of the firm can adequately cope with the new level in future. The reasons for a stable dividend policy include:-

   (a) The informational content of dividend. Here, the dividend charges are equated to profitability. A cut in dividend for example, may be interpreted to mean a decline in the firms profit potentials.

   (b) Many shareholders especially those who rely on dividend as the only source of income prefer a stable dividend policy to an unstable one.

   (c) A stable dividend policy reduces the investors uncertainty as to future dividend streams.

3. Constant Payout Ratio

   Most firms adopt a constant payout ratio. This means that a fixed percentage of total earnings will be paid out in dividends.

4. **Small Regular Quarterly Dividend Plus year end extra**

This is a combination of 1 and 2 above. A constant quarterly payment is made and if the firm has more earnings can declare an extra dividend at the end of the year.

Dividend Policy - The Relevance versus/irrelevance Debate

One important question that relates to the dividend policy of the firm is whether dividend policy affects shareholders wealth. Dividend policy can be looked at as a financing decision. This is because as long as the firm has investment projects whose returns exceed the required rate of returns it will use retained earnings.

The increase in equity base will support to finance these projects. If the firm has retained earnings left over after financing all acceptable investment opportunities, these earnings will then be distributed to stockholders in the form of cash dividend. In this type of situation, dividend is a passive residual. If dividend policy is treated as a financing decision therefore dividends are irrelevant. If investment opportunities promise a return greater than their required return, the investor is happy to have the Company retain earnings. On the other hand if the return is less than the required return, the investor prefers cash dividends. Two distinct opinions are found in the literature on the importance of dividend. The first one is the irrelevance argument while the second one is the relevant argument. The first school is led by Modigliani and Miller while the other is led by Durand, Lintner and Gordon[21].

M & M Assumptions (Irrelevant Argument)

(a) That Companies or firms operate in a tax-free world. The implication of these assumptions is that investors are not bothered whether they receive dividend or capital gain.

(b) There is perfect and complete capital market with no transaction and flotation costs. The implication of this is that investors can sell their shares any time without extra costs. And that investors can raise finance at the same cost.

(c) The existence of fixed investment policy. The firms investment policy is not affected by its dividend policy. With these assumptions, M & M argued that given the investment decision of the firm, the dividend payout ratio is a mere detail. It does not affect the wealth of shareholders. They believed that the value of firm is influenced by the earning power of the firms assets or its investment policy. Hence, the manner in which the earnings are split between dividend and retained earnings will not affect the value of the firm.

The Relevance Argument

Gordon et al believe that there is a relationship between a dividend policy of the firm and the value of the firm, hence they have proposed that the dividend policy of the firm matters. Their argument include the following[22]:-

(a) That risk aversion among equity holders tend to make them value earlier dividend more highly than later dividend since later dividends are riskier. In essence, the tried to use the "bird in hand" argument.

(b) Short-term market fluctuations combine with continued market perfection such as the existence of transactions cost make it difficult for investors to adjust their income pattern to their desired consumption pattern.

(c) Dividend may be regarded as conveying about the prospects of the firm and they have an information value which is reflected in share prices.

(d) It is unrealistic to suppose that investors are in agreement about the risk and return characteristics of the firm. e.g. some investors may have access to more reliable information than others.

(e) The tax positions of the investors and potential investors may cause a price differential between low pay out firms and high payout firms.

M & M disagreed with the relevance arguments. In the first case, they proposed that risky dividend exist because of risky Net Operating earnings and these risky NOE influence prices whether earnings are retained or distributed. To them, a shareholder has two options with his dividends. The first option is to consume and second option is to invest. If the second option is chosen there is no guarantee that the shareholder can do this better than the firm. On the other hand, if the first option is chosen, as long as the capital market is perfect and complete the shareholder can always make use of it to smoothen his consumption pattern over time. M & M acknowledge the possibility of a short-term fluctuation but pointed out that their hypothesis was a long-run equilibrium hypothesis. That dividend carries information, M & M proposed that it is information about risk and return prospects of the firm that can affect price and not a carrier of the information. M & M further argued that each firm tends to develop its own clientele of investors, e.g. investors who want capital gain will like a low dividend payout firm whereas, investors who favour large current income will prefer securities with a high dividend payout firm.

2.5 Controlling Profitability

The importance of profit for an enterprise cannot be over-emphasized. Company profits are expressed in Naira: profitability is the relationship (expressed as a percentage) between this profit figure and the capital used to

generate these profits and is a more useful indicator of how efficiently management is using total Company funds[23].

However, earnings per share rather than total profits is indication of shareholders wealth maximization as opposed to profit maximization.[24]

$$\text{Profitability} = \frac{\text{Profits}}{\text{Assets}} \times \frac{100}{1}$$

This is the product of two separate ratios: profit margin and asset turnover.

(i) Profit margin% $\times$ (ii) Asset Turnover

$$\frac{\text{Profits}}{\text{Sales}} \times \frac{100}{1} \times \frac{\text{Sales}}{\text{Assets}}$$

The sales values cancel out so that we are left with the profitability formula (R.O.C.E.).

$$\frac{\text{Profit before tax and Interest}}{\text{Assets}}$$

Ways to improve profitability

A closer examination of the above relationship reveals that profitability can be improved either by increasing the numerator (profits) or reducing the denominator (assets). Consequently, management has four variables under its influence or control that directly affect company profitability. They are:-

1. Price
2. Cost
3. Sales volume
4. Assets

(a) Increase selling price If price is raised while costs remain unchanged or rise proportionally less than the price increase, then the profit margin is obviously increased. However, in practice, there is a real danger of

reaction by customers who may turn to alternative suppliers; ideally, management should predetermine the elasticity or responsiveness of demand to price charges before taking action in this respect.

(b) Reduce Costs The problems and uncertainties of (a) may be overcome by approaching profit from the viewpoint of costs. In comparison with selling price, costs are more predictable and more easily controlled by managers, so that a more positive way of improving profit margins is to cut costs rather than to increase price. A comprehensive cost reduction exercise covering the areas of purchasing, production, selling and distribution administration and research and development could well produce significant savings in costs, and consequently a corresponding improvement in profit and the profit margin.

(c) Increase sales volume Thirdly, profitability can be increased by generating a higher sales turnover from the same value of ssets ie. a better utilization of assets.

(d) Reduce Capital Employed Finally it may be possible to reduce capital employed in the business. Then if sales are maintained from a smaller value of capital employed, then the more efficient utilisation of assets raises the asset turnover figure and directly contribute to a higher profitability percentage.

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CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Research Procedures

Robert Parket said "when you are seeking information in order to make a decision, you should consider looking at data that others have developed prior to undertaking your own research[1]". This study has been based on secondary data because of its special nature.

The Annual Report and Accounts of PAN is statutorily a public document and the researcher has access to five years consecutive reports upon which all the analyses are based.

Selected ratios will provide answers to some of the research investigations.

A sensitivity approach will be adopted to raise the equity capital of each year under review to the levels comprising the year's ordinary shares plus loan finances. All earnings before interest will be used in the computations required.

One assumption will be made, namely, that all earnings after tax is retained. That is to say no dividend is declared for the periods. This is to show the impact on the shareholders fund. It is however, anticipated that earnings per share will show a different picture from the shareholders fund.

3.2 Research Investigations

The first research investigation is whether earnings per share and shareholders' fund would not rise if PAN raises its equity capital over and above its interest earning loan finances. The sensitivity approach to test this has already been discussed under the research procedures.

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Whether anything could be done to minimize the amount of interest payments under the existing structure; is the second research investigation. Here, the researcher intends to make some suggestions on what he thinks could reduce the interest paid on borrowed funds.

The third research investigation is: whether PAN's profits over the years have been commensurate with its total assets.

Table seven Shows PAN total assets for five years

Table 7:- PAN TOTAL ASSET 1992 - 1996

1996	1995	1994	1993	1992
₦'000	₦'000	₦'000	₦'000	₦'000
1,521,132	359,048	359,472	363,694	381,051

Source: PAN Ltd.

The analysis will show whether enough profit in relation to the assets employed has been earned.

The fourth research investigation looks at how easily PAN could pay its current debts.

3.3 Methods of Processing Data

(a) Raising the share Capital The technique used will be to sum the fully paid capital with the short-term and long-term credits of PAN: divide the amount by two to obtain the number of ordinary shares at ₦2.00 per share. However, in order to avoid the yearly variations of capital an average for the five years considered will be taken.[2]

(b) Determining the profitability of PAN over the years vis-a-vis its total assets The ratio analysis technique will be employed here.[3]

(c) Determining the ease with which PAN can pay its current debts Again the ratio analysis technique will be used.

(d) Minimizing the interest being paid by PAN This will be a discussion session based on the researcher's experience at work.

Also some hypothetical figures will be used to illustrate the difference between nominal and effective rates of interest;[4] concepts which managers of firms finances should be familiar with in order to take decisions which could lead to minimal interest rates.

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CHAPTER FOUR

ANALYSIS OF DATA AND INFORMATION

4.1 PAN five year Financial Summary for the year ended Dec.31

The figures below together with those included in the appendices form the basis for the analyses which follow:

	1996	1995	1994	1993	1992
Capital Employed	₦'000	₦'000	₦'000	₦'000	₦'000
Called up share capital	105,000	105,000	105,000	105,000	015,000
Res. for bonus shares	-	-	-	-	90,000
Revaluation reserve	1,219,903	113,753	125,844	139,208	151,560
Revenue Reserve	196,144	64,366	43,138	22,086	12,589
Shareholders Funds	1,521,074	283,119	273,982	266,294	269,149
Longterm loans	58	94	1,594	4,594	10,862
Deferred Credit	-	75,835	83,896	92,806	101,040
	1,521,132	359,048	359,472	363,694	381,051
Fixed Assets	1,317,142	292,226	291,010	323,041	326,103
Net Current ASsets	203,990	66,822	68,462	40,653	54,948
	1,521,132	359,048	359,472	363,694	381,051
Turnover	5,472,528	4,629,887	3,298,682	2,964,463	2,871,106
Profit before Taxation	200,740	27,502	35,802	16,152	50,718
Education Tax	4,447	1,024	716	323	-
Taxation	48,765	-	14,034	6,332	20,287
Profit after taxation	147,528	26,478	210,522	9,497	30,431
Dividend	15,750	5,250	-	-	-
Earnings per share	2.81	0.50	0.40	0.18	4.06
Dividend per share	0.30	0.10	-	-	-

4.2 All Equity Finance

We saw from the problem analysis that the funds which PAN pays heavy interest were as follows:-

1996	1995	1994	1993	1992
₦'000	₦'000	₦'000	₦'000	₦'000
993,644	1,072,845	608,831	466,707	542,512

If we add the called up share capital for the relevant years to these loans, we arrive at what may be called the adequate capital requirement of PAN.

The obvious problem in this approach will be the yearly varying capital bases. We know that Company Capitals more often than not remain stable for a long time, for example, PAN was incorporated in 1975 with ₦15 million capital and it remained so till 1993 when a bonus share capital increased it to ₦105 million. Since then, the capital base has remained the same till now.

In order to avoid the envisaged yearly variations of capital, the researcher intends to take the average figure for the five years. Raymond P. Neveau, in the fundamentals of managerial finance said: "In Computing earnings per share and dividend per share, the denominator used represents the number of common shares outstanding as of December 31. This procedure implicitly assumes that these shares were outstanding for the entire 12 months. When the number of common shares outstanding changes, significantly during the year, an average of the outstanding shares is used in computing per share financial ratios". As a matter of fact, PAN's commitments with respect to Commercial papers and Bankers Acceptances change weekly when some are "redeemed" while others are accepted.

Thus, the Capital requirements of PAN were as follows:-

1996	1995	1994	1993	1992
₦'000	₦'000	₦'000	₦'000	₦'000
1,098,644	1,177,845	713,731	571,707	557,512

The average figure is ₦823,887,800 which gives 411,943,900 ordinary shares at ₦2.00 per share.

Now recasting the Profit and Loss Accounts for the years under review we have:-

	1996	1995	1994	1993	1992
	₦'000	₦'000	₦'000	₦'000	₦'000
Gross Profit	461,327	486,214	398,963	257,507	268,838
Other Income	1,161	1,119	2,028	3,159	4,636
Earnings before Tax	462,488	487,333	400,991	260,666	273,474
Taxation	(138,746)	(170,566)	(140,346)	(91,233)	(95,716)
Earnings after tax	323,742	316,767	260,645	169,433	177,758
Earnings per share	0.786	0.769	0.633	0.411	0.432

4.2.1 **Shareholders Fund**

In calculating the shareholders fund, the researcher assumes that all the earnings after tax is retained. This is not strange because from 1988 to 1996 (9 years) PAN has declared dividends five times.

	1996	1995	1994	1993	1992
	₦'000	₦'000	₦'000	₦'000	₦'000
Share capita	823,887	823,887	823,887	823,887	823,887
Revaluation Reserve	1,219,930	113,753	125,844	139,208	151,560
Revenue Reserve	323,742	316,767	260,645	169,433	177,758
	2,367,559	1,254,407	1,210,376	1,132,528	1,153,205

While the shareholders' funds have significantly increased in the all equity situations, probably because of the "injection" of new funds in the form of ordinary share capital and larger revenue reserves, it is noteworthy that the Earnings per share in 1996 and 1992 under the high gearing structure were larger than the all equity situations for the same periods. However, the EPS was better in the all equity structure in 1995, 1994 and 1993.

A close examination of the profitability ratios under the two financial structures might be more revealing than the earnings per share seen above.

4.3 Measures of Profitability

Profitability ratios are of two types: those showing profitability in relation to sales, and those showing profitability in relation to investment. Together, these ratios indicate the firms efficiency of operation. The term investment may refer to total assets, capital employed or the owners' equity. Accordingly, many profitability ratios in relation to investment can be calculated. The ratios discussed here are:-

1. Return on Stockholders' equity
2. Return on Assets.

4.3.1 Return on Stockholders Equity

The Return on Stockholders' equity $\frac{\text{Earnings after taxes}}{\text{Shareholders fund}}$

Year	Geared Structure		All Equity Structure
1996	147,528,000 / 1,521,074,000		323,742,000 / 2,367,559,800
	= 0.097	=	0.137
1995	26,478,000 / 283,119,000		316,767,000 / 1,254,407,800
	= 0.094	=	0.253
1994	210,522,000 / 273,982,000		260,654,000 / 1,210,376,800
	= 0.768	=	0.215
1993	9,497,000 / 266,294,000		169,433,000 / 1,132,528,800
	= 0.036	=	0.150
1992	30,431,000 / 269,149,000		177,758,000 / 1,153,205,800
	= 0.113	=	0.154

Return on Stockholders' equity.

	1996	1995	1994	1993	1992
	%	%	%	%	%
Geared Structure	9.7	9.4	76.8	3.6	11.3
All Equity Structure	13.7	25.3	21.5	15	15.4

The return on equity shows the amount which each Naira of ordinary shareholders funds is able to earn in return. The time series analysis indicate that apart from 1994 when each naira of the shareholders fund earned 76.8 kobo as against 21.5 kobo of the all equity situation, the performances of the all equity structures have been generally better than the levered situation as shown above.

Since the researcher has no access to industry average, he stops at the time series analysis and does not know whether the above performances are good or bad.

4.3.2 **Return on Assets**

$$\text{Return on Assets} = \frac{\text{Earnings after taxes}}{\text{Total Assets}}$$

We shall consider the two situations as before the highly geared and the all equity situations.

From the five year summary we obtain the total assets thus:-

1996	1995	1994	1993	1992
₦'000	₦'000	₦'000	₦'000	₦'000
1,521,6132	359,048	359,472	363,694	381,051

For the all equity structure, the total assets could be deduced from the fact that the capital employed equals total assets.

	1996	1995	1994	1993	1992
	₦'000	₦'000	₦'000	₦'000	₦'000
Shareholders fund	2,367,559	1,254,407	1,210,376,	1,132,528	1,153,205
Long-term loan	58	94	1,594	4,594	10,862
Deferred Credit	-	75,868	83,896	92,806	101,040
	2,367,617	1,330,336	1,295,866	1,229,928	1,265,107

The above figures could be broken down into fixed and Net Current Assets for the respective years but since they must be equal to the Capital Employed as above, we go ahead with the analysis using those figures.

YEAR	GEARED STRUCTURE	ALL EQUITY STRUCTURE
1996	147,528 / 1,521,132	323,742 / 2,367,617
	= 0.097	= 0.137
1995	26,478 / 359,048	316,767 / 2,367,617
	= 0.074	= 0.238
1994	210,522 / 359,472	260,645 / 1,295,866
	= 0.586	= 0.201
1993	9,497 / 363,694	169,433 / 1,229,928
	= 0.026	0.138
1992	30,431 / 381,051	177,758 / 1,265,107
	= 0.080	0.141

Return on Assets

	1996	1995	1994	1993	1992
	%	%	%	%	%
Geared Structure	0.097	0.074	0.586	0.026	0.080
All Equity Structure	0.137	0.238	0.201	0.138	0.141

It could be seen that under the existing structure, PAN earned good return on its assets in 1994 only (58.6%). In 1996 it earned 9.7%, 7.4% in 1995, 2.6% in 1993 and 8% in 1992. Such a performance was generally below the cost of debt finances in those years.

Comparing this with the all equity situation, we discover that the earnings improved significantly: 13.7% in 1996, 23.8% in 1995, 20.1% in 1994, 13.8% in 1993 and 14.1% in 1992. This suggests that the all equity situation was better for PAN.

4.4 Measures of Short-term Solvency

However profitable a business might be in the long-run, its survival depends amongst other things, on its immediate ability to repay its bills as and when they fall due. If its funds are overinvested in fixed assets (ie. it is underfinanced relative to its scale of operations) this may not be possible. Creditors may thus be given the power to foreclose: The current ratio and the quick ratio are two important measures of short-term solvency.

4.4.1 The current Ratio

The current ratio $= \frac{\text{Current Assets}}{\text{Current Liabilities}}$ measures the

extent to which short-term asset holdings can suffice to repay short-term liabilities if the latter were forced to be paid all at once. Here, we are going to examine PAN's current ratios from 1992 to 1996. The figures are picked from the Annual Report and Accounts of PAN.

YEAR	CURRENT ASSETS / Current Liabilities		
1996	1,993,948 / 1,789,958	=	1.114 times
1995	1,841,172 / 1,774,350	=	1.038 times
1994	1,414,746 / 1,356,284	=	1.050 times
1993	1,233,568 / 1,192,915	=	1.034 times
1992	1,524,153 / 1,469,205	=	1.037 times

All financial literatures suggest that the current ratio should be 2 or above. Based on this, one could therefore say that PAN's current ratios have not been very good.

4.4.2 **Quick Ratio (Acid Test)** Shows the extent to which all liquid assets excluding inventories will suffice to pay all short-term liabilities if the necessity arose to repay all of these immediately.

YEAR	CURRENT ASSETS - INVENTORIES / Current Liabilities		
1996	1,993,948 - 1,789,958 / 1,789,958	=	0.121 times
1995	1,841,172 - 1,571,676 / 1,774,350	=	0.152 times
1994	1,414,746 - 1,090,684 / 1,356,284	=	1.050 times
1993	1,233,568 - 801,088 / 1,192,915	=	0.363 times
1992	1,524,153 - 1,131,035 / 1,469,205	=	0.268 times

It is widely accepted that the Quick ratio should be 1 or above. It then suggests that PAN's quick ratio has been too low.

4.5 Minimizing Interest Payments

It is sound financial management to secure short-term funds at the lowest possible cost. The least expensive method of borrowing is the use of the open-book account. Even when overdue, a borrower usually pays no interest on open accounts. Generally, the rate on interest bearing obligations is affected by money-market rates and by the amount of risk assumed by the lender. The lowest charge, called the prime rate, is the interest rate quoted by larger city banks on loans made to their most credit worthy customers.

In Computing costs, business firms and consumers need to be aware of the difference between nominal and effective rates of interest. The nominal rate of interest is that stated on the instrument used in connection with the loan which does not take into account any financial charges. The effective rate of interest, or the annual percentage rate (APR) is the true interest cost which is higher than the nominal rate.

The effective rate on loans repayable on an instalment basis in almost double the nominal rate because interest is calculated on the full amount of the loan for the entire borrowing period despite the gradual reduction of the actual amount owed[2].

To illustrate, assume that a business buys a new pick-up truck for ₦7,000.00. The business turns in an old truck as a down payment of ₦1,000.00 and makes a loan for the remaining ₦6,000.00. It agrees to repay the ₦6,000.00 at a nominal interest rate of 8 percent a year in monthly installments for 2 years. The monthly payment is calculated as follows:-

2 x (₦6000 x 0.08)	=	₦960 (nominal interest for 2 years)
₦6000 + 960	=	₦6960 (actual size of the loan)
₦6960 - 24	=	₦290 (monthly instalment)

To approximate the effective rate of interest, we use the formula.

$$E = \frac{2 \times p \times c}{a(n + 1)}$$

Where E = Effective rate of interest

P = Number of payments in a year

C = Cost of the loan in Naira

A = Amount of loan.

N = Number of instalment payments

Substituting the facts given in the example for the letters in the formula, the approximate effective rate of interest is 15.36%.

$$E = \frac{2 \times 12 \times 960}{₦6000\ (24 + 1)} = \frac{₦23040}{N150,000} = .1536 = 15.36\%$$

It has been observed that some banks either by omission or commission charge higher than normal in their financial charges. One of the ways of minimizing this high interest charges is to recalculate the charges in line with the ruling tariffs provided by the banks. In PAN the treasury department usually writes all the banks it has business with at the beginning of the year, requesting for their current tariffs. One officer is assigned the duty of "bank charges recovery". This is a computer-based operation which is usually tedious but has proved a worthwhile exercise. Millions of Naira has been recovered from various banks each year. Without such recoveries, the interest charges recorded in PAN books could have been much higher.

.6 Findings

The Second-tier Foreign Exchange Market (SFEM) introduced by the government in 1986 has resulted in high costs for the Completely Knocked Down (CKD) parts and other local content inputs of the car industry. In order to breakeven and make profits, high prices are fixed for Peugeot Cars. Only few cars are now sold. PAN as a matter of fact operates below 10% of its installed capacity.

The gains from debt financing in PAN has gone beyond the optimal level and total cost has risen considerable thereby reducing all returns to the real owners of the enterprise. It has been shown that all the earnings after tax in the all equity structure considered were higher than the existing geared structure. For the periods examined, 60% showed an Earnings Per Share in favour of all equity while 80% of the period favoured the all equity in the profitability ratios looked into.

The measures of short-term liquidity show that PAN's short-term asset holdings cannot sufficiently repay short-term liabilities if the latter were forced to be paid all at once.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

In 1996 PAN had an asset base of ₦1.56 billion with a total turnover of ₦5.4 billion.

An all equity structure was simulated and analysed alongside the existing highly geared structure. The profitability ratios indicate that PAN is not earning enough returns on its total assets while the liquidity ratios show that PAN cannot sufficiently repay its short-term liabilities if the latter were required to be paid all at once.

Interest payments on borrowed funds from banks could be minimized by the enterprises recalculating their bank charges because huge sums of money have been recovered in PAN by so doing.

5.2 Conclusions

PAN is really over-trading. If the Annual Reports and Accounts are anything to reckon with, the shareholders wealth is not maximized under the existing highly geared structure and under the present capacity utilization.

5.3 Recommendations

From the researcher's point of view, the main problems with PAN are: the under-utilization of installed capacity because of high prices of Peugeot cars and the high cost of servicing loan finances. He thus puts up the following recommendations which affects both the Federal Government of Nigeria and PAN Management.

The Government should take strong measures to strengthen the purchasing power of the naira. One way of doing this is to vigorously pursue the line of industrialization because there is a high correlations between industrialization and economic development. It is when Nigerians shift their emphasis from

buying and selling to manufacturing and exportation of quality goods that foreigners would look for the Naira and its value would appreciate. To achieve this, the Nigerian Government must be seen to get involved like the Japanese Government. In Japan, the government spurred economic development by abolishing institutional obstacles to economic development by pioneering in the establishment of modern enterprises in infrastructure, industry and even banking. If this suggestion would take a long time to yield results, the government can in the interim fix a more reasonable exchange rate for the naira. This can bring about a reduction in car prices which in turn will result in increase in sales volumes in PAN with its attendant profitability.

Again, the Government can reduce the high tariffs on CKD with a strong warning to PAN Management to translate such a gesture in car prices.

Finally, PAN Management should increase its Capital base in line with the Minister of Industries recommendations.

It is hoped that when these recommendations are implemented, sales volumes would increase while the shareholders wealth would be maximized.

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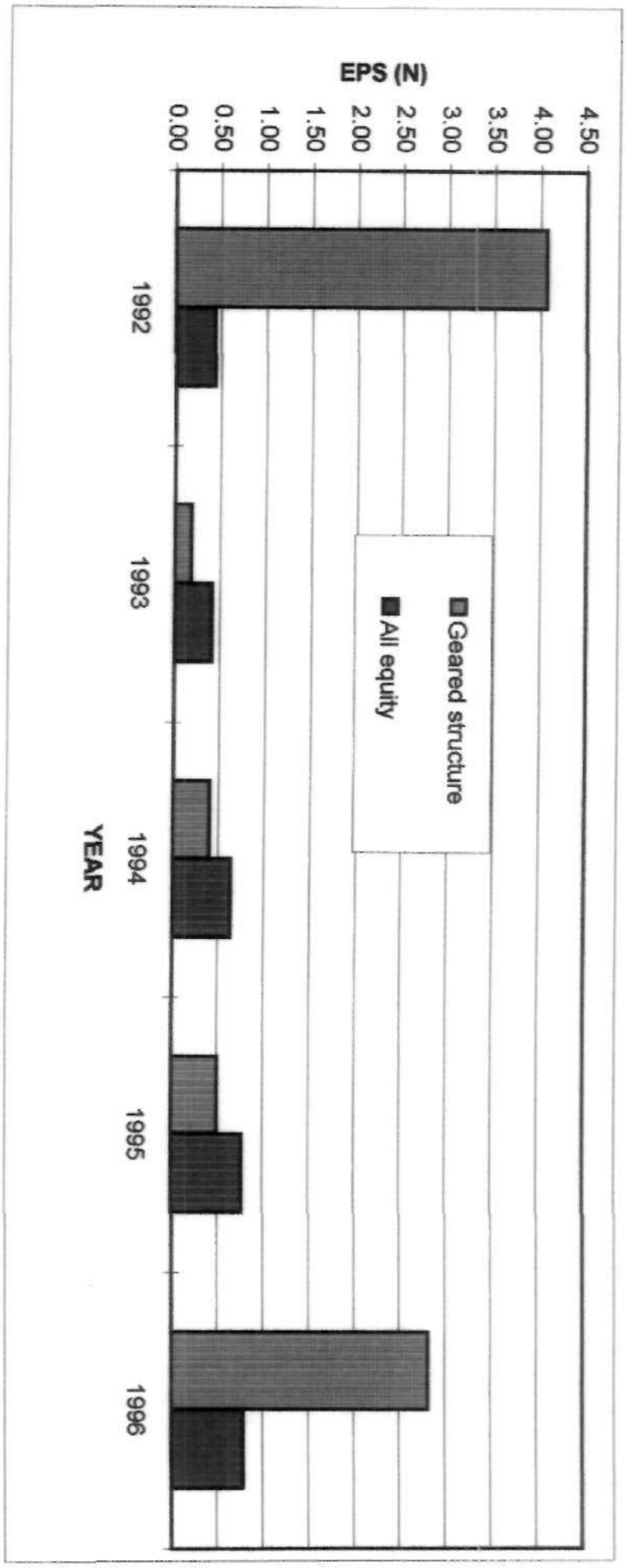
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Earnings per share 1992 - 1996

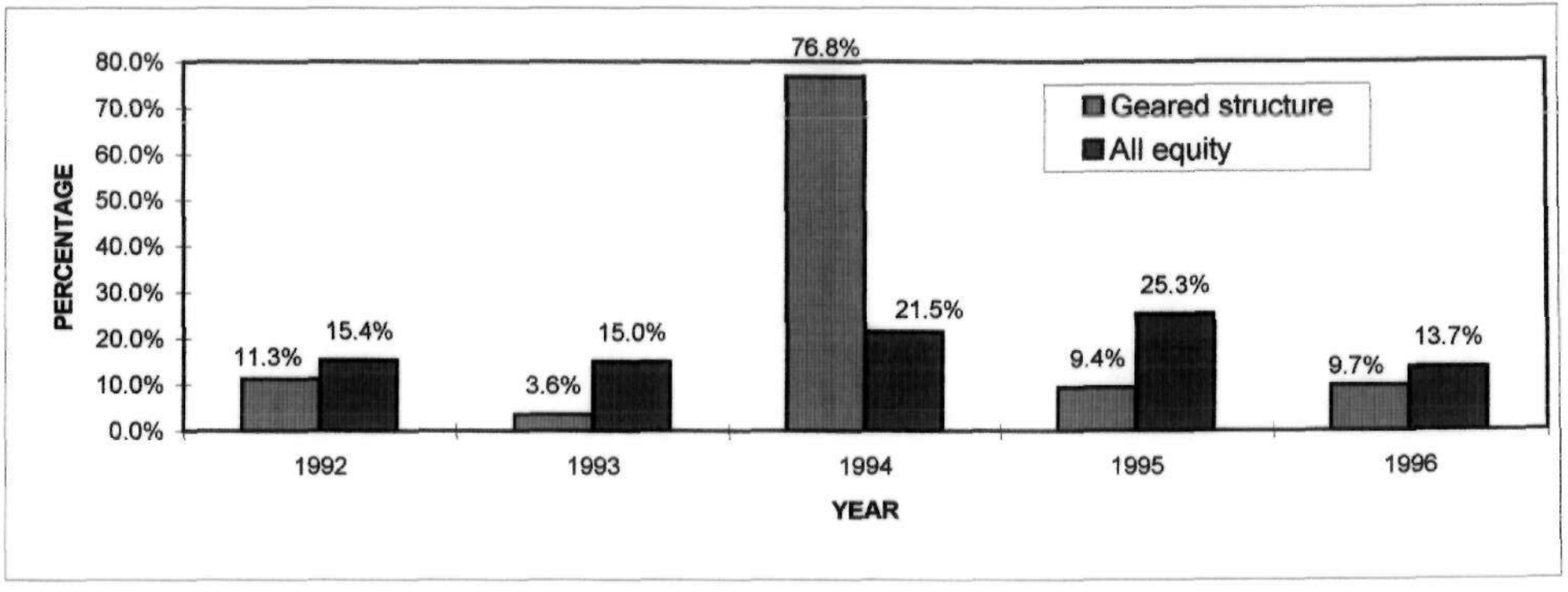
Years	1992	1993	1994	1995	1996
Geared structure	4.06	0.18	0.40	0.50	2.81
All equity	0.432	0.411	0.633	0.769	0.786



Return on stockholders Equity 1992 - 1996

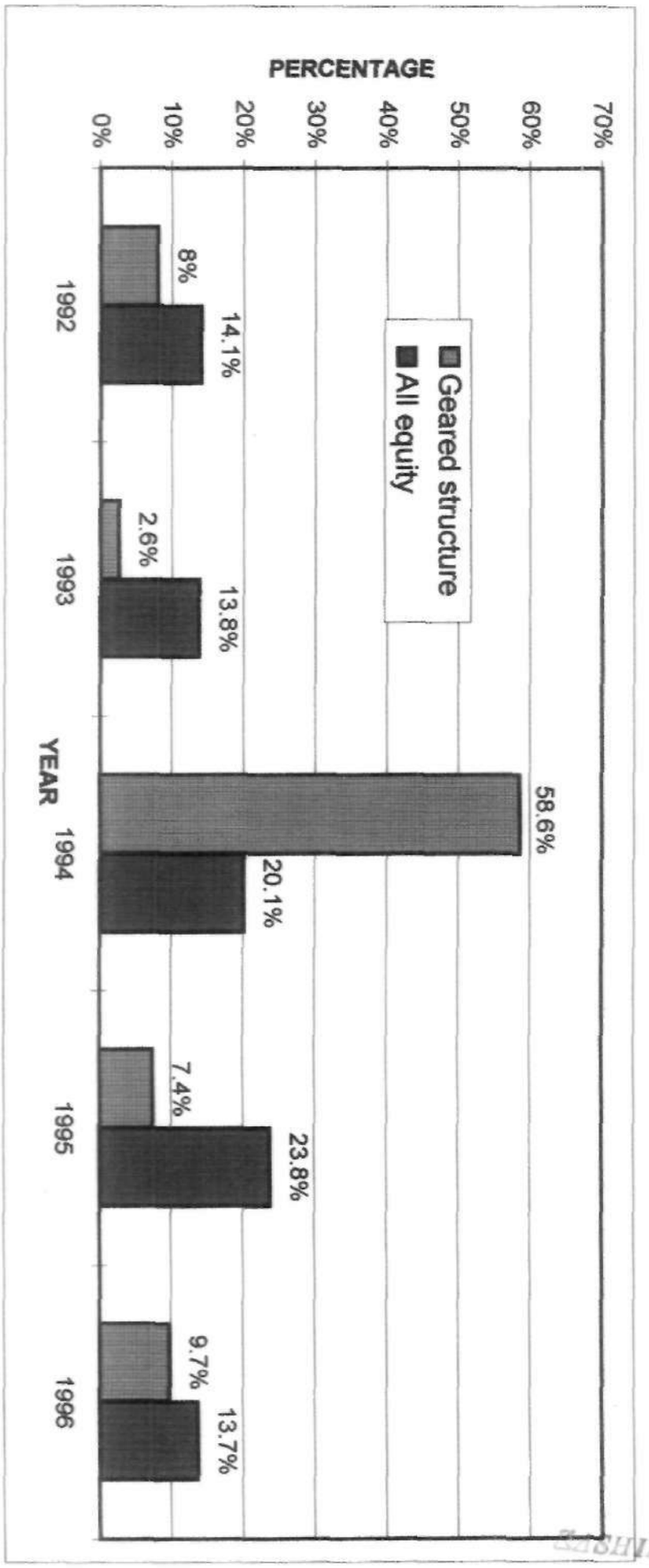
Years	1992	1993	1994	1995	1996
Geared structure	11.3%	3.6%	76.8%	9.4%	9.7%
All equity	15.4%	15.0%	21.5%	25.3%	13.7%

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Return on Assets 1992 - 1996

Years	1992	1993	1994	1995	1996
Geared structure	8%	2.6%	58.6%	7.4%	9.7%
All equity	14.1%	13.8%	20.1%	23.8%	13.7%



SHIM IBRAHIM LIB

Balance Sheet
As at December 31, 1996

	NOTES	1996	1995
		N'000	N'000
Fixed Assets	2	1,317,142	292,226
		1,317,142	292,226
Current Assets			
Stock and work in progress	3	1,776,944	1,571,676
Debtors and prepayments	4	174,086	50,867
Cash in hand and at bank		17,341	46,610
Cash in bank Fem account		25,577	172,019
		1,993,948	1,841,172
Current Liabilities	5	1,789,958	1,774,350
Net Current Assets		203,990	66,822
		1,521,132	359,048
Long Term Liabilites	6	58	94
Deferred credit	7	-	75,835
		1,521,074	283,119
Capital and Reserves			
Called up share capital	8	105,000	105,000
Revaluation reserve	9	1,219,930	113,753
Profit and loss account	10	196,144	64,366
		1,521,074	283,119

Major General Olu Bajowa (Rtd)

Ag. Chairman

Mr. F. Gouyon

Managing Director

See notes to the financial statements.

Balance Sheet

As at December 31, 1995

	Notes	1995 N'000	1994 N'000
FIXED ASSETS	2	292,226	291,010
		292,226	291,010
CURRENT ASSETS			
Stock and work in progress	3	1,571,676	1,090,684
Debtors and prepayments	4	50,867	48,738
Cash in hand and at bank		46,610	72,738
Cash at bank Fem account		172,019	212,857
		1,841,172	1,424,746
CURRENT LIABILITIES	5	1,774,350	1,356,284
NET CURRENT ASSETS		66,822	68,462
TOTAL ASSETS LESS CURRENT LIABILITIES		359,048	359,472
LONG TERM LIABILITIES			
Deferred credit	6	94	1,594
	7	75,835	83,896
		283,119	273,982
CAPITAL AND RESERVES			
Called up share capital	8	105,000	105,000
Revaluation reserve	9	113,753	125,844
Profit and Loss Account	10	64,366	43,138
		283,119	273,982

Major General Olu Bajowa (Rtd)
Ag. Chairman

Mr. F. Gouyon
Managing Director

See notes to the financial statements.

Balance Sheet

As At December 31, 1994

	Note	1994 N'000	1993 N'000
FIXED ASSETS	2	291,010	323,041
CURRENT ASSETS			
Stock and work in progress	3	1,090,684	801,088
Debtors and prepayments	4	48,467	43,840
Cash in hand and at bank		72,738	153,789
Cash at bank Fem account		212,857	234,851
		1,424,746	1,233,568
CURRENT LIABILITIES	5	1,356,284	1,192,915
NET CURRENT ASSETS		68,462	40,653
TOTAL ASSETS LESS CURRENT LIABILITIES		359,472	363,694
LONG TERM LIABILITIES	6	1,594	4,594
Deferred credit	7	83,896	92,806
TOTAL ASSETS LESS LIABILITIES		273,982	266,294
CAPITAL AND RESERVES			
Called up share capital	8	105,000	105,000
Revaluation reserve	9	125,844	139,208
Profit and Loss Account	10	43,138	22,086
		273,982	266,294

MAJ. GENERAL OLU BAJOWA (RTD.)
AG. CHAIRMAN

F. GOUYON
MANAGING DIRECTOR

See notes to the financial statements.

BALANCE SHEET

AS AT DECEMBER 31, 1992

	Notes	1992	1991
		₦'000	₦'000
FIXED ASSETS	2	326,103	326,000
		326,103	326,000
CURRENT ASSETS			
Inventories	3	1,131,035	615,822
Receivables	4	42,121	17,869
Cash in hand and at bank		106,294	123,292
Cash at Bank Fem deposits		244,703	200,607
		1,524,153	957,590
CURRENT LIABILITIES	5	1,469,205	905,590
NET CURRENT ASSETS		54,948	52,000
TOTAL ASSETS LESS CURRENT LIABILITIES		381,051	378,000
LONG TERM LIABILITIES	6	10,862	17,819
Deferred Credit	7	101,040	109,209
TOTAL ASSETS LESS LIABILITIES		269,149	250,972
CAPITAL AND RESERVES			
Called up share capital	8	15,000	15,000
Reserve for bonus issue	23	90,000	-
Revaluation reserve	9	151,560	163,814
Revenue reserve	10	12,589	72,158
		269,149	250,972

ALHAJI UMARU S. NDANUSA
CHAIRMAN

JACQUES MANLAY
MANAGING DIRECTOR

See notes to the financial statements.

Five-Year Financial Summary

For the year ended December, 31

	1995 N'000	1994 N'000	1993 N'000	1992 N'000	1991 N'000
CAPITAL EMPLOYED					
Called up share capital	105,000	105,000	105,000	15,000	15,000
Reserve for Bonus Shares	—	—	—	90,000	—
Revaluation reserve	113,753	125,844	139,208	151,560	163,814
Revenue reserve	64,366	43,138	22,086	12,589	72,158
Shareholders' Funds	283,119	273,982	266,294	269,149	250,972
Long term loans	94	1,594	4,594	10,862	17,819
Deferred Credit	75,835	83,896	92,806	101,040	109,209
	359,048	359,472	363,694	381,051	378,000
Fixed assets	292,226	291,010	323,041	326,103	326,000
Net current assets	66,822	68,462	40,653	54,948	52,000
	359,048	359,472	363,694	381,051	378,000
Turnover	4,629,887	3,298,682	2,964,463	2,871,106	2,140,875
Profit before taxation	27,502	35,802	16,152	50,718	10,164
Education tax	1,024	716	323	—	—
Taxation	—	14,034	6,332	20,287	4,066
Profit after taxation	26,478	21,052	9,497	30,431	6,098
Dividend	5,250	—	—	—	—
Earnings per share	N0.50	N0.40	N0.18	N4.06	N0.81
Dividend per share	N0.10	—	—	—	—

Five Year Financial Summary

For The Year Ended December 31:

	1994	1993	1992	1991	1990
	N'000	N'000	N'000	N'000	N'000
CAPITAL EMPLOYED					
Called up share capital	105,000	105,000	15,000	15,000	15,000
Reserve for bonus shares	–	–	90,000	–	–
Revaluation Reserve	125,844	139,208	151,560	163,814	24,944
Profit and Loss Account	43,138	22,086	12,589	72,158	66,060
Shareholders' funds	273,982	266,294	269,149	250,972	106,004
Long term loans	1,594	4,594	10,862	17,819	55,042
Deferred credits	83,896	92,806	101,040	109,209	23,639
	359,472	363,694	381,051	378,000	184,685
INVESTMENT OF FUNDS					
Fixed assets	291,010	323,041	323,103	326,000	86,267
Net current assets	68,462	40,653	54,948	52,000	98,418
	359,472	363,694	381,051	378,000	184,685
Turnover	3,298,682	2,964,463	2,871,106	2,140,875	1,251,758
Profit before taxation	35,802	16,152	50,718	10,164	25,456
Education tax	716	323	–	–	–
Taxation	14,034	6,332	20,287	4,066	10,183
Profit after taxation	21,052	9,497	30,431	6,098	15,273
Dividend	–	–	–	–	2,500
Earnings per share	N0.40	N0.18	N4.06	N0.81	N2.04

FIVE YEAR FINANCIAL SUMMARY

FOR THE YEAR ENDED DECEMBER 31:

	1992	1991	1990	1989	1988
CAPITAL EMPLOYED	₦'000	₦'000	₦'000	₦'000	₦'000
Called up share capital	15,000	15,000	15,000	15,000	15,000
Reserve for bonus issue	90,000	-	-	-	-
Retained profit	30,431	6,098	12,773	8,032	6,519
Short term loans	3,917	4,533	866	696	821
Long term loans	10,862	17,819	11,059	12,000	563
INVESTMENT OF FUNDS					
Fixed assets	326,103	326,000	86,267	88,625	94,306
Net current assets	54,948	52,000	98,418	96,174	71,145
Investments	-	-	-	67,786	107,264
Turnover	2,871,106	2,140,875	1,251,758	713,942	618,014
Profit before taxation	50,718	10,164	25,456	16,173	10,865
Taxation	20,287	4,066	10,183	6,641	4,346
Profit after taxation	30,431	6,098	15,273	9,532	6,519
Dividend	-	-	-	1,500	750
Earnings per share	₦ 4.06	₦ 0.81	₦ 2.04	₦ 1.27	₦ 0.87
Dividend per share	-	-	-	₦ 0.20	₦ 0.10