

PRIVATE FINANCING AND THE GROWTH OF CORPORATE ENTERPRISES*

BY

JAIME C. LAYA**

It is fairly simple to sketch the general outlines of the financial operations of Philippine business, despite the fact that available statistics are rather spotty. Accepting at face value some of the prevailing commentaries concerning the Philippine private financing picture, one easily concludes that credit is difficult to come by, and that whatever is available is terribly expensive.

Certainly, the manifestations are visible enough. New loans are difficult to obtain from private commercial banks and many existing credit lines have in fact been reduced in part or in whole. Many private firms have tended to delay payments of obligations, not only to financial institutions but also among themselves in the course of normal trade credit. The large government financial institutions have in general been short of cash, such that for practical purposes, a de facto moratorium on loan operations has existed for several months now. Interest rates have reached new peaks, reaching a high level of 16 to 18% per annum on treasury bills about a month ago. For various reasons, the situation is just about the same in the case of foreign borrowings sought by the Philippine government or by private companies and financial institutions.

This paper attempts to summarize the current financial situation and is divided into three major sections: (1) financing needs of Philippine business, (2) available financing sources, and (3) national monetary policy and its effect on industry financing.

*Prepared for a seminar conducted by the Congressional Economic Planning Office (CEPO), 30 September 1970.

**Jaime C. Laya, B.S.B.A., C.P.A., M.S.I.M., Ph.D., Dean of the College of Business Administration and Holder, IBM (Philippines) Professorial Chair in Business Administration, University of the Philippines.

FINANCING NEEDS OF PHILIPPINE BUSINESS

As companies operating in the context of a developing economy, Philippine industrial financing needs can be conveniently identified as:

- 1) financing needs for the expansion of existing companies,
- 2) financing needs for the establishment of new industries or business enterprises,
- 3) additional financial requirements brought about by increasing price levels, and
- 4) financing needs caused by the general credit tightness in the economy and the corresponding need for business organizations to assume a greater financing burden in behalf of their customers.

With a population growth of about 3.5% a year, an overall industry growth of at least an equivalent percentage is necessary in order to maintain goods and services at existing levels. Expansion is furthermore a necessary part of the industrialization objectives of the economy. A third major reason for necessary expansion is the changing regional population pattern in the Philippines. Philippine business will have to be prepared to handle the requirements of population movements, say, into cities and into the less settled areas of the country. Fourth, the encouragement of export industries and industrial diversification will call for increasing investment needs.

The magnitude of the investment necessary in order to be able to meet the expansionary, employment and other national development objectives is indicated in the four-year development plan that was adopted by the National Economic Council (NEC) in June 1970. A total of ₱23.56 billion is required for private investment purposes during the four-year period 1971-1974, large parts of which are intended for the mining, manufacturing and agricultural sectors. Necessary private investment is expected to rise from ₱5.62 billion in fiscal year 1970 to ₱6.35 billion by fiscal year 1974, representing an annual growth of 4.8%.

These investment requirements are estimated to be essential in the achievement of various output targets in agriculture, industry, transportation, power and other sectors of the economy. For example, in

agriculture, the physical output targets are as follows: 5.5% annual increase for crop production, 2% annual increase for forestry, 8% annual increase for fishery. In industry, the specific objectives are, among others, to promote the development of intermediate and capital goods industries, to encourage industries that will subject traditional exports to further processing, and to generate greater employment opportunities. Similar specific targets are established for other sectors of the economy.

Since new Philippine business enterprises have tended towards high debt-equity ratios (a maximum of 3:1 being considered as still acceptable), it is significant that the plan states that direct government assistance — including loan assistance — will be centered on priority projects that are identified in the investment priorities plans of the Board of Investments (BOI).

The financing needs of existing business enterprises are themselves quite significant, particularly due to increasing price levels that have affected most of the factor inputs needed in production. Due to the advent of the floating rate, the cost of imported raw materials have increased by 50% or more. The cost of capital equipment has similarly gone up. With the recent approval of an increase in the minimum wage, a chain of salary and price increases started, causing increases in the costs of local raw materials. The price situation has been aggravated by the increase in fuel and power costs, which of course arose partly from the floating rate, and partly from the implementation of the minimum wage and other salary increases in the companies concerned. Just a quick run-through of the various components of a company's balance sheet will demonstrate that financial requirements clearly increase as a result of these price changes.

First of all, if a firm keeps on hand as inventory, say, one month's production requirements, and if these raw materials are entirely imported, the investment requirement in inventories will automatically increase about 60% if the company maintains its policy of keeping one month's inventories on hand. If these raw materials inventories consist of locally manufactured goods, the increased financing cost will probably be closer to a 20 to 30% increase, about the magnitude of the rise in wholesale price indices during the month-period ending April 1970.

Working capital commitments in accounts receivable are also likely to rise. If a firm extends credit for sixty days under normal conditions, it is likely first of all that the collection period will lengthen beyond this normal sixty-day period. Furthermore, any price increases would tend to raise the peso volume of business activity even without any increase in physical sales volume. This would also tend to increase the amount tied up in accounts receivable.

Expansion programs that were caught in midstream during the imposition of the floating rate and the subsequent price increase situation would obviously raise the financing requirements necessary to be able to complete these expansion plans. The increased costs of spare parts, equipment replacement and other working as well as permanent capital needs will all lead to an increased requirement for additional financing on the part of existing business organizations.

Even cash balances, which normally depend on the level of a company's monthly expenses, will have to rise proportionately if the firm wishes to maintain its previous level of liquidity.

The increased working capital requirements of companies can be easily gauged from a sample survey of about 300 companies, which is conducted annually by SyCip, Gorres, Velayo & Company. The results of the survey show that cash balances of companies increased by about 122% over the seven-year period 1962-1969. Accounts receivable rose by 138% during the same period of time, inventories by 64% and total current assets by 120%. Future requirements greater than these past figures can probably be expected over the next few years.

Companies that have long-term foreign currency obligations could well experience a serious liquidity and profitability squeeze. Not only would interest payments rise by the amount of the change in the peso-dollar rate, but the amortization payments themselves on the principal of the loan would also increase by the same proportion. Thus, companies having foreign currency obligations not only have to raise that much additional pesos to be able to service their obligations; they will also have to increase their profit margins in order to offset the increase in the effective interest cost. For example, even allowing for the tax deductibility of losses on foreign exchange revaluation, a five-year loan negotiated in 1969 at an effective cost of 10% a year would in effect cost 24.7% with the institution of the floating

rate. Merely to break even, minimum investment profitability would have to be about 2.5 times the previous breakeven level.

In many instances, the increase in the peso equivalent of foreign currency obligations has resulted in such an unfavorable capital structure or cash flow position that financing sources have reduced or are reluctant to renew existing credit arrangements for the firm concerned.

FINANCING SOURCES

The four-year development plan previously referred to does not fully anticipate the sources of financing for the projects proposed. However, the plan for industrial expansion provides that about 1/3 of the investment requirements in fixed capital will come from personal savings, particularly as paid-up capital of newly registered enterprises and capital increases or reinvestments in existing firms. Personal savings are expected to generate ₱3.75 billion over the four-year period 1971-1974.

The second largest source of long-term capital is non-government financial institutions, particularly commercial banks, who are expected to provide financing for 26.8% of the total, or ₱3.06 billion. Foreign investment is expected to account for ₱2.64 billion, or 23.1% of total requirements. Corporate savings in the form of undistributed profits and surpluses are expected to provide ₱1.43 billion of financing over the four-year period, or 12.6% of total requirements. Finally, the government financial institutions, mainly the Development Bank of the Philippines (DBP) are expected to provide financing in the amount of ₱1.02 billion, or 8.9% of the total.

Working capital requirements are relatively smaller and sum up to only ₱2.85 billion over the planning period. About 60% of this is expected to be provided by commercial banks, and the remaining 40% by trade creditors.

Very little up-to-date data is available on different financial intermediaries. The most current data are those for commercial banks who had loans outstanding of about ₱8 billion as of the end of June 1970. These has reflected a slight increase over the previous six months, presumably representing an attempt to accomodate the increased credit

requirements of Philippine business. The increase was funded primarily through a reduction in bank investments.

For immediate purposes, it is useful to look into loans presently outstanding as an indicator of the relative size of potential funds-generating ability. Current data is lacking but loan and investment portfolio figures in table I are indicative of relative magnitudes.

The major sources of short-term financing are commercial banks (₱7.8 billion in outstanding loans), savings and rural banks, financial institutions (particularly Bancom Development Corporation, with loans outstanding of ₱30.5 million and the Agricultural Credit Administration [ACA] of ₱106.6 million) and finance companies. No aggregate data is available for finance companies, although one of the largest such firms, the IFC Group of Finance Companies, had outstanding receivables and investments of ₱153.5 million as of the end of 1969.

The data indicates the relatively easier availability of short-term financing relative to long-term financing from major financing sources. This is seen in table II, which shows that outstanding short-term loans at 30 June 1969 were about ₱7.2 billion, compared with outstanding long-term loans of ₱3.9 billion. Excluded here are foreign loans and loans made by insurance companies, finance companies and various other lenders. The inclusion of other local sources probably would not alter basic relationships, however.

In terms of loan purposes, short-term credits are available for commercial, industrial and agricultural uses, in that order. The largest share of long-term funds, however, goes to real estate and consumption financing, industrial loans follow. Further details as of 30 June 1969 are shown in table II.

More recent data indicate the continuation of these practices. Loans extended by government non-bank financial institutions are mostly for real estate and consumption loans. As of May 1970, loans outstanding in these two categories came to more than 88% of the loan portfolios of these government non-bank financial institutions (SSS, GSIS, ACA, NIDC). The private non-bank financial institutions, on the other hand, favored industrial and commercial loans, which accounted for 31.5 and 26.8% of their loan portfolios as of May 1970. Public utilities received 23.1% of the loans outstanding of these

latter financial institutions. It should be noted of course that the loans granted by government financial institutions are, for the most part, long-term obligations, while those of private entities are sometimes short-term loans.

Since the private non-bank financial institutions are relatively smaller compared to the government institutions, a greater overall emphasis on real estate and consumption loans emerge in the combined financing picture for non-bank institutions, which accordingly show that real estate and consumption loans account for 81.9% of total loans outstanding against industrial, agricultural, commercial, and public utility loans, which account for only 15.6% of the total.

Insurance company investments are mainly in stocks and fixed deposits (34.94%), followed by policy loans (22.27%), and real estate (20.53%). Only the remaining 18.74% are available for mortgage loan financing.

Available estimates of loan release potential of the DBP, GSIS and SSS for fiscal years 1971 and 1972 indicate that new loans available for agricultural and industrial proponents come to ₱265.5 million in 1971 and ₱396.2 million in 1972. Details are shown in table III.

Internally generated funds constitute a major source of financing and national income data for 1968 show business savings amounting to ₱727 million after taxes. Accumulated depreciation charges for the same year came to P2.615 billion, indicating the availability in 1968 of some ₱3.3 billion from internally generated financing.

The picture for the first half of 1970 appears to be bright enough, judging from the midyear reports of some large corporations. The mining companies have benefited by the peso floating rate and in some firms, 1970 earnings are about 50% higher than the comparable 1969 period. Manufacturing companies were not quite fortunate, but at least one large company reported an increase of about 22% in its net income applicable to common stock. Banks, similarly, have shown additional profit during the first half of the year. Data is still incomplete, however, to be able to form a clear picture of the internal financing source situation.

The Philippine stock markets were quite active beginning in 1969. The large number of new corporations that were formed during

this period indicates the availability of fairly substantial amount of equity financing, particularly for basically speculative companies formed for oil or mineral exploration. A good number of existing corporations also made successful preemptive offerings of securities. This was true not only of speculative issues but also of industrial enterprises, such as the Paper Industries Corporation of the Philippines, which had of course the backing of various benefits under the Investment Incentives Act.

GOVERNMENT MONETARY POLICY AND INDUSTRY FINANCING

Currency in circulation increased by about 10% between 1968 and 1969 and by about 20% between 1969 and 1970. Peso demand deposits increased by about 19 and 13% during the same comparable periods. These changes in money supply outran increases in domestic productivity, thus in effect increasing the purchasing power competing for available goods, which have not increased in the same proportion. The normal consequences that one would expect would be an increase in price level, and an increase in the demand for imported commodities. This proved to be the case and the outcome has been an increase in price levels, about 6.64% during the six-month period July 1969 to January 1970. Increases were also reflected in other price indices, something that was aggravated by the institution of the floating rate in February 1970. Without going into the causes of these increases in money supply and the price level, a major share of the responsibility fell on the monetary authorities to dampen the increase in the price level. It was accordingly announced that money supply will be gradually reduced, eventually by a total of some ₱600 million.

Some of the specific contractionary measures in force include the following:

- 1) An increase in Central Bank (CB) rediscount rates to the following: (a) rice and corn financing – 6%, (b) export financing – 7¾%, and (c) all other credit instruments – 10%. There was, moreover, a comprehensive rediscount ceiling that was established at 100% of the paid-up capital of commercial banks as of 31 December 1969, with further restrictions on the amount actually available. As of 6 May 1970, the CB suspended indefinitely an increase in the rediscount ceilings, as well as borrowings at the preferred rates

for rice, corn and export financing. The net effect of all these restrictions is basically the limitation of bank borrowings from the CB.

- 2) Reserve requirements were gradually increased, reaching a maximum of 20% beginning on 1 August 1970. Such increases leaves the bank with only 80% of its deposit liabilities available for lending or for its own secondary reserves.
- 3) The imposition of the export tax also has a contractionary effect inasmuch as the peso equivalent of the dollar proceeds of selected products comes to less than the prevailing exchange rate. The net effect is that the business community pays more pesos for dollars than the amount it gets when the dollars are sold to the CB. The difference between the buying and selling price for dollars in effect represents pesos going out of circulation and going to the CB for the stipulated purposes of the export tax.
- 4) The most recent contractionary measure adopted by the CB is the issuance of the Certificates of Indebtedness, which carry a highly attractive 9% tax-free interest rate. This is equivalent to about 13.85% in before-tax interest income. The funds attracted by the Certificates of Indebtedness will in effect be immobilized over a three-year period – the maturity of such certificates.

As was the basic intention, these contractionary measures have led to high interest rates and the scarcity of financing is evident in the high effective yield of treasury bills and other credit instruments. It will also be probably reflected in a greater scarcity of new equity funds, as investors and financial intermediaries are attracted to high-yielding fixed income securities.

Greater control is also being placed on foreign financing arrangements. In the past, imports of capital equipment were easily financed on deferred payments basis up to as much as five years. These capital acquisitions were not necessarily foreign exchange generating, such that by the time installments on the foreign financing were due, the CB did not always have the dollars available to sell to the companies needing

them. In some instances, projects were so unfeasible in the first place that companies did not even have pesos with which to buy the necessary dollars.

To be able to control, therefore, the foreign exchange flows of the economy, the Central Bank External Debt Management Office was established to institute some system in the management of the country's foreign exchange position. Through this office, attempts are being made to establish priorities for foreign loan financing, as well as to lengthen the term of such foreign loans to correspond more closely with the foreign exchange generating or substituting capabilities of the project in question.

The consequences of all these restrictive measures are the symptoms evident to all of us. These include measures adopted by banks and other financing institutions to restrict the availability of the bank credit and to increase the cost of credit whenever these are available. The former is done simply as a measure to ration the available credit to the many potential borrowers. There is accordingly a reluctance to lend to new clients, to expand credit lines, and in some instances there are moves to cancel old credit lines. In order to protect the profitability of these financial institutions, who now have themselves to borrow at higher rates, the increased interest costs and other changes are passed on to borrowers. Other requirements are also imposed, such as compensating deposits, a phase-out of overdraft lines and other measures calculated to increase the effective yield on loans granted. Finally, these are also in evidence in the increased obstacles being placed to foreign borrowings by Philippine business.

GENERAL OBSERVATIONS AND SUMMARY

Some major characteristics of Philippine business financing are summarized below.

- 1) Many new enterprises, particularly the large ones, depend on debt financing for a large part of their capital requirements. A 3:1 debt-equity ratio is still considered as acceptable. Most, if not all, of these businesses, could not have started without the fairly large debt component. Since the major sources of domestic long-term financing are government financing

institutions, and since foreign debt financing can be obtained only with governmental approval and/or guarantees, there is a large leeway within which the development of the nation's industrial capability can be effectively encouraged through coordinated financing. The move to closely coordinate the activities of the DBP, SSS, GSIS and PNB and to more closely tie-in investment and export incentives to investment availability is clearly a sound step in this direction.

- 2) Supervision and coordination among private financial intermediaries can be improved. For example, commercial, savings and rural banks are within the authority of the CB. Development banks and other government financial institutions are almost autonomous. Insurance companies are supervised by the Insurance Commission under the Department of Finance. The Department of Commerce and Industry (DCI) (through the Securities and Exchange Commission [SEC]) exercises some control over finance companies and securities markets. The ACA is regulated under the Land Reform Code. Housing loans and financial arrangements are made by the Home Financing Corporation (HFC) and the Philippine Homesite and Housing Corporation (PHHC). Cooperatives and credit unions are directed by the Cooperative Administration Office. In the past, many little banks were granted permission to open. With minimal overall financial planning and direction, it is inevitable that the various financial intermediaries have grown at varying speeds and not necessarily in full harmony with national development goals.
- 3) Related to the above-mentioned items is an apparent tendency for various sectors to try to solve their financing needs by enlisting congressional support for the establishment of special purpose banks, such as a workers' bank, an export bank, a cooperatives bank, a coconut industry bank, which have all been proposed in the past. To be sure, some amount of discrimination must be practised in the establishment of new government-supported financial institutions, since it is possible that the same objectives can be achieved within

existing institutions. This facilitates coordination, not to mention the prevention of additional overhead costs in the system.

- 4) Investors and depositors are still insufficiently protected from unnecessary risks. With the critical need to tap for productive investment as much personal savings as possible, necessary measures must be adopted to assure savers of the safety of financial institutions. Unfortunately, this has not yet been attained. The Philippine Deposit Insurance Corporation (PDIC), which has just been established, will probably be unable to stem a large-scale bank run. Insider trading and manipulation in stock markets are often rumored. Very little effective safeguards exist to protect a stockbroker's clients in the event of failure of the brokerage firm. Insurance companies have been known to fail despite existing regulatory arrangements. Bank inspection should be more frequent and more thorough, the increase cost possibly to be financed by an increase in bank examination and supervision fees. In general, it seems that the effectiveness of investor or depositor protection still needs a thorough review.
- 5) It has often been said — and recently embodied in the justification behind a proposed amendment of the Central Bank Act — that the CB has not always been able to exercise the monetary checks and controls that may be necessary to balance the effects of fiscal policy or the effects of developments in various other sectors of the economy. The proposed measures to make the CB more independent would probably make it a more effective institution.
- 6) Many financial institutions — banks or otherwise — could well have been established to facilitate meeting the financial requirements of specific industries or companies. These clearly place an otherwise disinterested depositor at a disadvantage, since loan funds may thus be concentrated with a narrow range of borrowers, and thus, be unduly exposed to risk. His welfare can be safeguarded by closer bank inspection and as a long-range measure, by stricter controls over the creation of new financial institutions.

- 7) One socially (if not necessarily economically) significant area that is often overlooked involves the financing needs of low-income groups and the very small trading operations. In public markets and other such places the standard practice has been the so-called cinco-seis. Five pesos (say) borrowed at the beginning of the day as a market vendor's initial capital must be repaid at the end of the day with ₱6. Even at simple interest, this comes to a rather hefty 7,300% a year. The loan maturity is sometimes extended to one week, in which case the annual simple interest rate falls but to a still high 1,040%. The needs of this economic sector are overlooked by existing organized institutions and certainly are not reached in the implementation either of the Usury Law or the Truth in Lending Act.
- 8) A heavy emphasis on collateral rather than on project feasibility still exists in most lending institutions, even in rural and development banks. This attitude needs to be reconsidered if Philippine financing institutions are to effectively service the needs of small farmers and other borrowers who are unable to post the full collateral requirements. Perhaps a scheme of local loan guarantees or soft loan quotas by larger financial institutions could help alleviate this problem.
- 9) The large number of financial institutions is an effective way of gathering savings, but not necessarily the most efficient way from the standpoint of financing the economy's resource needs. Single loans involving large amounts are obtainable only from foreign sources or from consortia of local banks. Often, the loanable funds of the system are scattered in numerous small projects or on consumption/construction loans rather than to more major, or capital projects. Ways can perhaps be designed to clearly distinguish these functions of funds gathering and funds lending, and perhaps to encourage close working relationships or mergers among financial institutions, the better to be able to direct funds flows consistently with other national economic goals.

Proportionately more of the CB's domestic credits have gone to the public sector than to the private sector. Between 1967 and 1969, for example, credits to the commercial banking system rose by 25.9%, or ₱296.8 million, while credits to the national government rose by 43.8%, or ₱763.7 million. At the same time, it is the private sector that gets squeezed, just in any operation to mop up excess liquidity. While the private sector is an ultimate beneficiary of increased government expenditures, it is difficult to plan when government orders increase during a fairly short period, and then stop abruptly with an accompanying tightness in credit that could well affect even the basic operations of the firm.

TABLE I

**LOAN AND INVESTMENT PORTFOLIOS OF PHILIPPINE
FINANCIAL INTERMEDIARIES***

	<u>Due from Banks</u>	<u>Loan Receivables</u>	<u>Investments</u>	<u>Total</u>
Commercial banks	₱430.5	₱7,822.6	₱1,641.1	₱9,894.2
Saving banks	97.6	277.7	115.0	490.3
Rural banks (7/31/69)	33.9	416.5	7.0	457.4
Development banks	256.3	2,088.2	328.5	2,673.0
Non-bank financial institutions	n.a.	1,009.3	n.a.	1,009.3
Insurance companies (12/31/71)	n.a.	331.3	481.2	812.5
Foreign guarantees of DBP (total approvals, to 3/31/70)	—	—	—	3,126.1

*As of 31 December 1969 except when otherwise indicated.

TABLE II
LOANS OUTSTANDING OF MAJOR FINANCIAL INSTITUTIONS
30 JUNE 1969
(Amounts in Thousands)

	Short-Term Loans*		Long-Term Loans**		Total***	
	Amount	%	Amount	%	Amount	%
Agriculture	₱1,670.4	23.16%	₱ 499.4	12.65%	₱2,169.8	19.44%
Industrial	1,772.9	24.58	1,343.5	34.03	3,116.4	27.93
Commercial	1,980.1	27.45	62.2	1.70	2,047.3	18.35
Real estate	499.7	6.93	1,353.4	24.28	1,851.1	16.59
Consumption	180.8	2.51	476.4	12.07	657.2	5.89
Government and government capital	677.9	9.40	68.2	1.73	746.1	6.69
Other	<u>₱7,213.9</u>	<u>100.00%</u>	<u>₱3,948.0</u>	<u>100.00%</u>	<u>₱11,160.0</u>	<u>100.00%</u>

* Commercial, savings and rural banks.

** Development banks and non-bank financial intermediaries.

*** Excluded are insurance companies, finance companies, foreign financing, trade creditors, etc.

Data from Central Bank Statistical Bulletin, Vol. XXI, No. 4 (December 1969).

TABLE III
ESTIMATED LOAN RELEASE POTENTIAL
OF THE DBP, SSS AND THE GSIS
1971-1972

	1971	%	1972	%
Service feature loans	₱ 237.0	22.74%	₱ 245.0	22.91
Agricultural	83.2	7.98	83.1	7.77
Industrial	182.3	17.49	313.1	29.28
Real estate (including housing projects)	196.5	18.96	291.0	27.21
Other loans	30.8	2.96	28.4	2.66
Advances on guarantees	312.3	29.97	108.7	10.17
Total	<u>₱1,042.1</u>	<u>100.00%</u>	<u>₱1,069.3</u>	<u>100.00%</u>

Source: Four-Year Development Plan, FY 1971-1974.