Corporate Finance : Overview of Company Financing in Tanzania

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Abstract: Companies operating as commercial entities must have sufficient cash balances to facilitate their smooth operations. Cash requirement can be raised from different sources, ranging from equity, various forms of debt, to internally generated funds through retained earnings which would otherwise be distributed to shareholders (Myers and Myers, 1991; J.Gitman, 1991). These sources are broadly classified into internal and external; while internal financing does not embrace financing costs, external financing takes into consideration the way finance is raised. Each of these methods carries a cost to the firm and risk to investors.

As debt increases, shareholders as residual claimants, bear this risk through dividend volatility. This has certain implications in terms of costs as the higher the risk the higher the return to compensate for increased risk. This paper evaluates various sources of finance available to Tanzanian companies and their relative costs. Whereas companies in the developed world have different sources from which they can raise finance, developing countries have limited and undeveloped sources.

The financial system is explained in terms of what it offers in the finance function. The role of financial system, including its efficiency to corporations is examined. The long run interrelationship between economies, interest rates in particular, is illustrated to show how they are reflected in finance costs. The effects of financing policy in terms of costs is also examined, including the costs associated with getting finance from all available sources. These sources are compared and contrasted to United Kingdom (country from which Tanzania inherited most of its financial system as former colony) sources to evaluate the most cost-effective. The basic Miller and Modigillian theories on finance are reviewed to assess their applicability and impact on firm operations in Tanzania

INTRODUCTION

Literature on firm financing has identified company finance to be an important resource for facilitating companies' activities to maximize their objective functions, which include value of the firm and shareholders wealth (see among others, Knot, 1983). In well-established and industrialized countries, investors and shareholders alike, guided by the performance of firms, undertake to invest in a particular company with the expectation of a high return (also known as profit) for foregoing current consumption (see also Fama, 1970). Investors and shareholders are also aware of the high profit - high-risk profile in that investment undertakings with prospects of higher return are also undertakings with high risk.

In less developed countries (LDCs) such as Tanzania, the return risk portfolio is not clearly established and hence less understood, largely due to undeveloped markets and other structural capital constraints. This paper uses practice and evidence from firms in United Kingdom to analyse the behaviors of firms in the light of capital outlays. The paper is divided into five parts. The introduction briefly defines corporate finance. Part two deals with theoretical assumptions involved in the analysis of corporate finance. Part three shows examples of behaviors of selected firms from UK. In part four, some illustrative case studies of Tanzanian firms in are discussed. Finally in part five, some conclusions and recommendations are made.

The Role of Finance in Company Performance

Finance plays an important role in the operations of the firm. Financing decisions involve determining optimal liquidity whether for working capital or investment purposes. According to Smith (1980) cash is "king." Without cash, many operations will come to a standstill. Customers and suppliers will lose confidence and collapse of the business is likely. Companies like Leyland DAF, the Dutch company went into receivership in 1993, resulting from low demand and consequently liquidity problems (*Financial Times*

1993). Suppliers lost confidence in the company and as a result, it could not secure materials or funds from banks. Tanzania's firms should learn from creative accounting practices, which let down such promising empires such as Polly Peck, Maxwell and Colorroll Plcs, both of United Kingdom. In 1994 the Tanzanian government decided to divest loss making parastatals. The objective of divesture was to relieve the government of the burden of debt and losses of public enterprises. The measure was also aimed at ensuring the availability of technology and skills not available in the country. Tanzanians will be sure of access to foreign markets while encouraging share ownership through equity investments.

There has been an increase in the number of companies going into receivership in Tanzania and in the UK from the end of 1980s and early 1990s. This has been attributed to their inability to secure enough cash from operations as well as from banks. Bank lending of the 1980's became a burden to many companies, as the expected boom did not materialise. Many companies went into recession with high levels of gearing, (defined as the proportion which company debt bears to the equity) and, with the downturn, servicing debts became expensive in declining profitability. In such circumstances, getting finance becomes difficult and expensive.

Tanzanian companies experienced almost the same problem. However, the situation is rather different, mainly due to the change in value of the currency. This affected those companies dependent on foreign finance. The extreme case is one company, Perma Sharp (1993) which was divested because of its inability to meet debt obligations. Many others were on the same trend. All in all, these problems came as a result of lack of enough finance to carry out operations, including payment of interest and dividends as well as repayment of current maturing loans (PSRC, *Annual Report*, 2001).

Sources of Finances

Having established the need for finance, the company will have to evaluate different sources available for raising required finance. In general terms, companies have two broad sources of finance - internal and external sources. These sources have been examined by researchers to determine their cost and preference. Debt financing is often more preferred than equity as new equity issues deliver a bad message to shareholders (Brearly & Myers, 1994). Although it is convenient and relatively simple to raise finance through debt, there are some limitations to the alternative.

For example both debt and shares can be traced in the secondary market. This process, known as securitisation, allows holders to exchange securities whenever they need to. Firms can also raise finance through securities on the strength of existing assets.

The market efficiency assumptions assist in an efficient allocation of resources. This is achieved through firm's interaction with forces and the managerial supervision exercised. The result is timely commercial and financial decisions directed towards meeting shareholders objective of profit maximisation (Adam, 1992). Finance is a scarce resource. Its availability can be costly. There is need to analyse the finance function carefully in order to enhance the value of the firm and consequently shareholders wealth. More importantly, determining the optimal level of finance and sourcing, is the fundamental task of management, which should be carried out without prejudice to other functions. Existence of different sources gives companies alternatives for evaluating cheaper sources and hence adopting the one with optimal benefits to the company.

THE FINANCIAL SYSTEM

Finance functions in an established and confident financial system comprise various institutions, which make the finance function possible. The

institutions involved are banks, capital markets, financial markets and financial intermediaries which ensure that the finance required by organisations is provided when needed. The financial system throughout the world has become complex which requires complex skills to operate. As Heynot (1981) notes, it is not a static system, but one that is continuously changing as new institutions and instruments are developed.

The UK Financial System

The British financial system is one of the most well developed systems in the world. It is a network comprising of banks, building societies, financial markets, stock exchange, derivative markets, insurance companies, pension funds and unit trusts that invest in various securities to provide finance to organisations. The above-mentioned institutions form sources of finance for both local and multinational companies.

At present, there are over 600 banks operating in the UK (Extel, 1994). The majority of these are foreign banks based in London to serve the needs of multinationals. The corporate bond market in the UK is not as developed as that of the USA. It provides a limited source of finance to companies. Profitable companies have another source, the retained earnings. UK companies rely more on retention, accounting for 59% of the source of finance.

Some rely on share issues in the stock market as exemplified by the right issues of the Lhonro plc, Anglo-Irish bank plc, BM Group, BTP plc and Caverdale Group plc. Each of the above mentioned source carries a definite cost. The London Stock Exchange provides the other source of finance to UK companies, where the listed companies can issue bonds, shares and other securities to get the required finance. These companies can also invest in the stock exchange by buying securities with profit potential in the future.

The London Stock Exchange is among the international exchanges where multinationals can issue their securities. Their global expansion has enabled them to get finance from different countries around the world at a low cost. This is aided by the use of derivatives to hedge currency exposures and the centralisation of the finance function. Derivatives facilitate the financing of multinationals' global operations. The instruments used include such derivatives as swaps, financial futures, forward contracts and currency options. Their value depends on the value of the underlying asset, currency, bond or shares.

In practice, derivatives do not constitute a source of finance, but are a means of minimizing the effects of exchange rate and interest changes on company assets. Firms do not issue these instruments to raise money, rather they buy or sell them to protect against adverse changes in various external factors (Breadly and Myers, 1993).

Through the use of derivatives, multinationals can borrow in different countries and currencies, without being adversely affected by the volatility of exchange rate and interest rate. British Petroleum Plc, for instance borrowed an equivalent of £1712m in more than seven currencies in 1992 (BP Plc *Annual Report and Accounts*, 1992). The use of swaps eliminated substantial exposure to different currencies BP Plc borrowed. This arrangement is possible in the UK because of the development of such markets and their confidence in the company involved. The borrowing status is enhanced by rating agencies like Standard and Poor and Moody credit rating agencies.

For multinationals to be in a position to operate in such markets, they have to meet prescribed credit ratings ideal for them to command the confidence of the public, through which they will be able to avoid extra premium paid for failure to meet investors' confidence.

Given the diverse nature of UK's financial structure, companies have a wide choice from which they can raise their required finance. They

range from local and international sources such as the Eurodollar and Eurobond markets which assist in raising finance across many financial centers simultaneously. They can also use corporate bonds (though limited in UK) and lease companies for raising their finance.

Under such a competitive environment, providers of finance try to offer the best service to their customers at the end of competitive price so as to retain customers. The prices are therefore market determined. Both the stock market and the financial markets are competitive in nature and they sometimes attain market efficiency, which is the precondition for the optimality of the perfect market.

INTERRELATION OF WORLD ECONOMIES AND EFFECTS ON DOMESTIC FINANCIAL SYSTEM

The UK financial structure is closely integrated with some of its major trading partners, such as USA, Japan and the European Union countries. Due to this integration, the effects of policy carried out in one-country spreads to the other and consequently affects domestic operations (See Appendix 1 on International Parity Conditions). The international parity conditions show that the effects of inflation can spread to the other country if there is no equilibrium in the exchange rate. The inflation differential between two countries will be reflected in the exchange rate (Madura, 1976). However, the international parity conditions hold in the long run. It is expected to be reflected in the economy after sometime, not immediately. The same applies for the interest rate under the international fisher effect between highly-integrated economies. The interest rate can be used to influence the exchange rate and the general monetary policy, the results of which affects the financing costs of companies.

Lowering the interest rate for any government indicates disequilibrium in international parity conditions as they affect domestic activities. The rate is lowered to combat speculations in the money market, arising because of imperfections in the market and the arbitrage activities. Given the wide range of sources of finance for UK companies, it follows that each company will try to utilise the most effective source to minimise finance costs. This fact drives the providers to find an optimal cost that is acceptable to both parties. The system makes borrowers contribute towards that optimal cost through maintenance of acceptable levels of debt that ensures providers of finance that their assets are safe and the company can meet its commitments. Those, which fail to achieve this objective, will have to incur additional risk premium.

The inability to extend borrowing has been observed in the case of British Petroleum plc. In June 1992, because of the group's recent financial performance and higher debt levels, the companies debt rating was downgraded by Moody's from Aa3 to A1 and by Standard Poor's from AA to AA-1(Steve Abe, 1992)." Downgrading the credit rating, had substantial effects in costs of financing operations. All multinationals are rated according to their debt levels and performance. Debt rating becomes important for multinationals that operate on a global basis.

The UK financial system provides the avenue for financing and investment activities to many companies, small and large. Its global integration gives companies more sources of finance for their securities for raising finance in different financial centers. These companies achieve international diversification, hence reducing financing risks. The existence of numerous sources of finance provides a wider avenue for corporate finance managers to choose from the best and most cost-efficient source of finance, leading to the maximization of the firm's value and consequently shareholders wealth (Appendix 2 and 3).

Tanzanian Financial System

As a developing country, Tanzania has an underdeveloped financial system composed solely

of banks as a source of finance to companies. Other financial institutions like the National Insurance Company (NIC) and pension schemes like PPF and NSSF, do not offer a means of finance. They mostly concentrate in investment in buildings and government securities (Appendix 4). There are no building societies to provide finance for acquisition of houses as well as other uses, allowing cash-rich insurance companies and pension funds companies, a big share of the housing market, mainly for renting to other companies and some individuals.

The introduction of stock exchange in 1995 where companies can trade their securities, as a mechanism of efficient allocation of resources has created a number of market perfections in the economy. There is no monetary expansion through subsidising loss-making companies. However, the privatisation policy is reshaping these companies. Inflation now stands at 5% while borrowing interest rates remains at 20%. The banking system, which is the main source of finance for companies was, until recently state owned and there are now various local and foreign commercial banks, which play the role of providing finance to Tanzanian companies.

Before the government sold NBC (now NBC 1997) the company was the sole bank to finance working capital requirements of private companies in Tanzania. NBC was faced by a huge demand for finance requirements. Credit creation was also limited because of low level of savings among Tanzanians. The bank's capital base was small and NBC could not raise finance by selling shares as there was no stock market, that purpose. Getting government subsidy was difficult but became more difficult in recent years due to the increasing deficit in government budget; and the move to limit deficit led to bank borrowing of 4.6% of GDP (United Republic of Tanzania, 1993). There were other specialised banks, which provide finance to specific projects. The Co-operative and Rural Development Bank (CRDB) catered for the provision of finance to co-operative unions towards the purchase of agricultural produce from peasants. They had a small, undeveloped commercial banking wing which functioned to finance basically small businesses, with priority to those in the rural areas. Other banks included Tanzania Investment Bank (TIB) whose main function was to finance large capital investments by government and a few private individuals with priority to those in rural areas.

The Tanzania Development Finance Company Limited (TDFL) was, and still is, a development finance company whose main objective is to secure foreign currency for local companies for use in buying capital goods not available locally. Other banks, mostly foreign, have not done much with regard to investments and loans to the business community in Tanzania. These are the CITI Bank, Standard Chartered, Exim, Malaysian Bank, Stanbic Bank and Barclays Bank. The aforesaid banks and the entire financial system is coordinated by the Bank of Tanzania, the Central Bank. Given the limited source of finance for Tanzanian companies and the state ownership of the banking system, there were many imperfections in the system, which were considered to be partly responsible for higher costs. They range from high government interventions and inefficiencies to lack of adequate capital to operations. This means that the amount of new funds available through commercial banking channels was limited, and in any event not adequate to meet the financing required to sustain a reasonable level of growth (Debs, 1981).

Competition among banks was absent as they were state monopolies. Inefficiencies and corruption were endemic (and still existing in a few sectors) in such systems, which directly or indirectly raises finance costs. As a result, the banks' ability to provide finance was severely affected. Effective lending will be difficult to achieve unless the banker is aware of who his/her competitors and collaborators are. The

inefficiences referred to above are not rare in African financial systems. Unfortunately, there are no supporting data for this but economic theory of demand and supply will tend to favour this conclusion in many countries.

The Tanzanian financial system was highly regulated and dominated by government. Political influences in many financing decisions were inevitable in a state-dominated structure. The government mobilised finance for the state-owned enterprises through taxation, foreign borrowing and retained earnings for very few (if any) state enterprises. Bank loans were advanced to state firms on political grounds, in some cases irrespective of their economic viability, security for the loan and in particular bank capital. In fact, many of the state enterprises were loss making and as a result, they became a liability to the state and taxpayers (Lipumba and Mbelle, 1993). A large number of parastatals, which dominated the manufacturing and trading sectors, continued to represent a substantial drain on the Tanzanian economy (IMF Survey of National Economies, 1994).

These loses became a liability to taxpayers as companies had to raise prices or get a subsidy from the government. The extreme cases include those which led to the liquidation of state companies like Sungura Textile, Mwatex, Bora Shoes, Tanzania Leather, The Kilimanjaro Hotel, Tanzania Breweries, Tanzania Cigarettes, TANITA and Aggregates Ltd etc. These companies and several others went into receivership because of large losses and inability to service loans inspite of subsidy received from the government.

The government intervened in the banking sector to provide loans to these companies in an attempt to achieve political goals. For instance TANITA processes cashewnuts bought from peasants. To assure peasant of the market, the government used subsidised the company through equity and soft loans. The market for the produce declined, leaving the company unable to pay loan and meet operations costs. The results were receivership case (Appendix 6). The financial sector would appear very underdeveloped in comparison with the financial sector in market economies (Kitchen, 1976).

Interest rates were also regulated by the government and were used as a monetary policy instrument. The banking sector was not sufficiently developed to engage effectively in the money markets. The problem was compounded further by the absence of a stock market as a secondary market to trade securities. Few companies were aware of the existence of the money market and few could participate as the majority had liquidity problems such that they could hardly participate in the money market. The few cash rich companies invested the excess cash by holding fixed deposits with banks and treasury bills. Interest rates (borrowing) went as high as 40% (currently borrowing interest rates stand at 20%). Even then, businesses could not borrow, which made it difficult for the banks to offer a reasonable deposits interest rate to its customers.

The deposits interests are as low as 3%. Due to an increased deficit in 1994, which drove the inflation to 26%, a number of fiscal measures were taken with a view to lowering inflation to 17%. These included strengthening collection of government revenues and lifting of subsidy to state firms. The government established the Presidential Parastatal Sector Reform Commission (PSRC), which was given the responsibility of selling the loss making state owned enterprises, e.g., TTCL, TCC, TOL, NBC, TBL, TPDC, of which a few are already listed in the Dar es Salaam Stock Exchange (Economic Survey, 2001).

Subsidising public enterprises has implications on the balance of payments, especially those dependent on the importation of raw materials and capital goods. This matter has become worse as a result of the change in the value of currency. Appendix 5 shows movements of the Tanzanian currency (Tshs) *versus* dollar over five years period.

This review has shown that Tanzanian financial system is now moving from a regulated one to a deregulated one. As a result, the Government is responding to these changes by restructuring the entire financial system.

The proposed system is likely to favour a market economy with competitiveness resulting from establishment of private banks to the establishment of stock market, which took effect in 1995/96 financial year. With the increasing pace of globalization, Tanzanian economy is not in isolation. Being agriculture-based, the export of agricultural products is expected to finance ever-increasing import bill (appendix 8) for both raw materials and some finished goods. Part of export earnings services the external debt. The effects of exchange rate and global economic performance are also reflected in the Tanzanian financial system.

FINANCING COSTS

Different Costs of Raising Finance

Companies obtain finance from different sources, ranging from shares and loan (debt) in various forms to the retention of profits. The finance raised has an alternative use. Consequences of the finance raised from using such funds other than the alternative use, (the opportunity cost) is the risk, which owners incur in terms of default in interest payment and dividend volatility. The elements are included in the determination of the cost of capital. Whether the company uses equity or debt to get the required funds is not the subject of this work. But management always strives to obtain a combination of both equity and debt that maximises the value of the firm.

The cost of raising finance through equity is referred to as the cost of equity, whereas that arising from loan is the cost of debt. The cost of debt and equity to the firm is the equilibrium rate of return required by investors (Moyer 1976). In setting the interest rate for rewarding investors, management should determine the interest rate that equates the present value of future investors interest receipts and repayment with the market price of bond. The share capital, on the other hand, is comprised of preference shares. These differ by the degree of risk they carry to investors, with ordinary shares being more risky because of being residual claimant to the profit distribution. The cost of capital is therefore the sum of the individual cost of debt, cost of equity and cost of retained earnings.

As mentioned above, common stock, (ordinary shares) are riskier, and hence the rate of return tends to be higher for extra risks assumed. The average cost of capital is the weighted sum of components' cost of capital. Brealey and Myers (1991) refers to it as weighted average cost of capital, (expected return on a portfolio of all the firms securities- used as a hurdle rate for capital investment) and it is calculated as follows:

$$WACC = ra = \left(\frac{D}{v} x\, rd\right) + \left(\frac{E}{V} x - re\right) \qquad (1)$$

where:
D= is the debt of the firm;
V= is the market of the firm as determined by stock market;
E= is the equity;
ra= is the firm's overall cost of capital;
rd= is the cost of debt; and
re= is the cost of equity.

The after tax cost of capital is given as:

$$ra = WACC = rd(1-T)\frac{D}{v} + re\left(\frac{E}{V}\right) \qquad (2)$$

where:
T is the corporate tax rate.

WACC is a traditional approach adopted in measuring the cost of capital using proportions of components to the market value.

Valuation of the Firm

The value of the firm is considered to be the present value of future cashflows to investors.

Firms with higher probability of meeting cash flow requirements of investors are assumed to have a higher value than those which cannot. They are assumed to be less risky.

In a market economy, determining the value of the firm is fairly simple as securities (bonds and shares) are traded and the equilibrium price established becomes the security price. The value of the firm may also be estimated by investors from financial statements. These are prepared by the director to show their accountability for the resources with which they have been entrusted. Being the agents, they have to show that they are implementing their duties satisfactorily. This is manifested through the ability of the company to pay dividends continuously. This accountability has influenced their role of reporting to shareholders. Creative accounting which was prominent in the 1980's was the manifestation of the agency theory. A value of the firm can be determined by looking at the future cashflow potential (fundamental analysis). One valuation model of the firm looks at the future dividend stream, using the dividend discount model. The formula used in discounting the dividends is given as follows:

$$P = \sum \frac{D_t}{(1+R)^t} \qquad (3)$$

where:
P is the current share price;
Dt is dividend paid in time t;
R is the return earned in the capital market on securities of comparable risk.
With constant dividend growth:

$$P = \frac{D}{(r-g)} \qquad (4)$$

Where g is the dividend growth factor. Other variables are as defined earlier.

For quoted shares, the price can be determined as prospects because r dividend payments will affect the expectations of investors and consequently the price. Directors as agents, try to ensure share price does not fall. A rise in share price is preferred as it signifies profitability and growth of the firm. It is also a signal for the increasing value of the firm. Investors will be willing to pay the price which equates the present value of future dividend payments and growth potential discounted at the appropriate costs of capital.

In Government-regulated economies, the possibility of evaluating the company may be minimal. The net assets referred to above can be the only alternative available. The 100% state owned companies may adopt this approach as the dividend paid goes to the government. For majority ownership, valuation takes the form mentioned above. Minorities have limited voting power, as a result, they cannot influence decision making. Minorities value their investment by looking at what goes to them through remittable dividends. All the risks inherent in investing in a developing country are considered for valuation purposes. In the UK, the value of quoted companies can be determined by the stock market. The Tanzanian situation is different. The proxy for the value can be taken as the value of net assets which, in most cases, are determined on historical cost basis. As a result, the firm's value may be incorrect. In Tanzania, some of the state enterprises have foreign companies as the minority shareholders. These are companies with the Government shareholding of more than 50%. These companies will be considering remittances or dividends abroad. They are also involved in the importation and export of goods from the country. Given the strict foreign currency regulations, repatriation is considerably difficult. To circumvent this situation, foreign subsidiaries may over-invoice imports and under-invoice exports to obtain part of the profit, which would not have been available for them through dividends.

The future of the state companies seems to be heading to market determination of the value of the firm. What the market expects from the

companies will be reflected in share price. The IMF, World Bank and donor countries have spearheaded the need for reforms to increase efficiency in utilizing resources offered. Privatisation, which is on-going since 1994, will increase the power of investors and through that make directors more accountable. It is expected that performance will improve when directors are held accountable for their actions, hence ensuring efficient allocation of resources.

In a planned economy where the government controls the majority of activities from production to finance, adoption of conventional valuation models may be limited. In some countries, political philosophies do not allow free operation of the financial system. The extreme is the total ban of the capital markets which are politically seen as instruments of capitalism. This eliminates the avenue for the firms to trade their securities, mobilise resources within the economy. Nwanko (1986), assessing the Nigerian financial system, observes that, most developing countries assumed that capital markets were capitalist instruments, and as such they were not adopted in their economies when these countries got independent. It is for this reason that many African countries do not have capital markets.

Compared with the UK, the Tanzanian financial system leaves behind many issues that affect the cost of capital mainly through cost of debt as shown below. The cost of equity capital can be determined as:

$$ke = \frac{D}{P_n} + go \qquad (5)$$

where:
D is the dividend,
Pn is the share price,
go is the rate of dividend growth.

Since few Tanzanian companies' shares are traded, and sometimes not very competitively, then it becomes difficult to assess the cost of equity capital. If we take the book value of the assets per share as a proxy, we find that book value is highly understated in many companies due to inflation. Rees (1982) financial analysis argument is that the use of market estimates, though volatile, provides an alternative and independent estimate of capital employed and hence the value of the firm. Book values are dependent on the current level of inflation and they may be substantially lower than the market value.

Compared with UK companies, many Tanzanian companies run at a loss and hence they cannot pay dividends to the Government. They have been incurring losses continuously such that determining the rate of dividend growth for cost of equity purposes is impossible. Companies borrowing from a bank had to pay an interest of 40% per annum, compared with an inflation rate of 26%. The 40% rate was the market rate. The existence of preferential credit policies for selected sectors of the economy created special problems, to include inflation and resource allocation problems. Tanzania cases of state influence on allocation of resources and consequently interest rates distortion involves those where Government had to intervene to help co-operative unions in Mbeya, Morogoro and Dodoma Regions to get credit from banks in order to buy agricultural produce. Many credits granted were not used for the intended purpose, hence misallocation of resources.

The debt-equity ratio is important in a market economy. The Government influence on financing decisions has decreased. Such decisions no longer dominate the risks of losing control through excessive borrowing. With as high gearing as that of TPPC, (Appendix 8) the risk of liquidation is maximized because the Government no longer owns the financiers (banks) and cannot influence their decision to act against the company. In a market economy, the increasing level of debt on company's capital structure will raise the concern of current and potential investors. As the firm increases its relative debt level, the cost of equity

capital (shown as ke in the equation 5) increases. This comes from higher return required by stockholders due to increased risk (possible dividend volatility) imposed by the traditional debt Under a market economy, additional finance in the above situation can only be obtained by paying a very high premium for the apparent interest payment default.

Defaults (as those in appendix 6) can only be written off with Government approval. The Government bears the risk, which lowers the cost of finance for these companies. It accepts as a shareholder, the burden of the losses resulting from insufficiency of assets to liquidate all liabilities. There is a close relationship among companies for the supply of inputs. This reduces significantly the impact of other creditors to force the troubled company into receivership.

In a market economy investors in company capital will evaluate their return in terms of the company to meet interest and dividends payments. Their required returns will be the rate that equates the present value of the future income to the current price/value of debt (Brealey, Meyers and Steve Lamby, 1991).

The Tanzanian situation makes it difficult to evaluate the actual cost for debt. The fixed interest rates charged for loans may be overstated or understated, as it is not adjusted for the extra risks to investors. Government's decision to underwrite debt is deemed to eliminate the risk, but if these companies borrow in foreign currency, they assume the exchange risk. Only when the risk is excessive does the Government assume the exchange risk. In a market economy as opposed to a planned economy, we have clearly separated parties, investors and the company. This means that determining the return and consequently the cost of finance (from companies point of view) becomes vivid.

Before 1994 the government objectives was to attain political goals and dominated the economic impacts of projects and consequently the finance cost. This made it difficult to get the right cost of finance. Neither the actual cost of equity nor debt could be determined by investors, as the Government was the equity holder as well as debt holder through state-owned enterprises and banks. Determining the market value was impossible as shares and bonds were not publicly traded. The future is bound to change with the establishment of private banks and Government divesture of state companies.

Different Perspectives of Gearing and Financing

Gearing is the share of finance, which company debt bears to the equity. It is expressed as long-term debt of a percentage of equity and debt. As gearing increases, fixed commitment in terms of interest increases, leaving more volatile profit before tax which is distributable to shareholders. Because of this volatility, shareholders will tend to demand higher dividend to match the risk. As mentioned earlier, excessive gearing lowers the credit status of companies, the effect of which is the extra premium to be paid in raising finance. Companies try to maintain their credit rating by improving performance and reducing debts. BP, mentioned earlier, is determined to reduce debts by £ 1bn yearly to restore its credit status. Tanzanian companies are not, strictly speaking, subjected to credit rating. These companies do not pay a premium for high gearing. The market operations are essential for the determination of the premium to be paid. With lliberalisation of financial services, many things will be determined by the market forces.

Tanzanian companies were highly geared (most of them have been divested) because of government interference in the availability of loan and inability to extend share capital since the incorporation of these companies.

Miller and Modigilian (MM) Propositions

The Miller and Modigilian (MM) propositions have been in use as models for determining the cost of capital and in particular, the effects of different

components on the value of the firm. Miller & Modigilian's propositions associate the value of the firm to the capital structure. The firm can use debt and equity in financing operations. MM propositions are based on market economy where in a perfect market, any combination of securities is as good as another(Bradley and Myers 1993). It is also based on efficient market hypothesis, and assumptions of zero tax and absence of transaction costs. These assumptions might not be relevant for Tanzania now, but with time such assumptions will be valid.

The MM propositions are three in number, each with very restrictive set of assumptions. It is assumed, for example, that the market value of the firm is independent of its capital structure. Miller and Modigilian argued that the market value of a firm is determined by discounting the expected total earnings at the same appropriate, all equity rate of return, and that through arbitrage process, the equilibrium value of the firm is determined.

The expected rate of return on equity increases linearly with the gearing ratio. This increase, they argue, results from additional risk taken by shareholders by adopting debt finance, and hence they will require compensation for that.

The expected return on equity of the firm with debt will comprise of a premium paid for additional debt on the firm's capital structure. As the cost of equity raises, it offsets the low cost of debt, thus restoring the equilibrium weighted average cost of capital. This assumes that the cut-off rate to be used in investment is the rate of return appropriate to all-equity firm.

As mentioned earlier, MM proposition was developed in a competitive capital market. In reality, directors concentrate on those activities which increase the value of the firm by identifying profitable projects rather than trying to increase wealth through dividend and financing decisions. What matters to them (directors) more is the cashflows to the firm. The tax shield would suggest that the firm can increase the level of gearing as long as it gains through tax shield. This is not always the case as increased gearing means increasing the cost of financial distress and bankruptcy threats. This cost will tend to limit the level of gearing. Issuing debt above equilibrium level (in market economy) will drive interest rates above their supply price which eliminates gearing benefits. In public limited companies, investors are worried by higher gearing which leads them to demand higher return for the extra risk involved. A formula for illustrating the value of the firm considering gearing, taxes and costs of financial distress is as follows:

$$Vg = Vu + PV \text{ of tax shield} - PV \text{ of financial distress} \quad \ldots\ldots(6)$$

where

Vg is the value of the levered firm;

Vu is the value of the unleveled firm (as in Linmark and Fox, 1991) and

Pv is the present value determined at the rate of return required by the shareholders.

The above formula suggests that after the marginal point, increase in gearing reduces the value of the firm (the value of the firm is inversely related with financial distress cost). Proponents of the importance of distress and bankruptcy costs argue that there is an optimal level of gearing at which the bankruptcy costs, the cost of capital and the tax reliefs are balanced (Samuels, 1986).

Authors indicate that the optimal level of gearing can be determined, beyond which increasing gearing means reduction in the value of the firm. Companies would continue to issue debt until the rate of interest being paid was equal to i/1-tc. At this point, extra interest paid in to the lender will be exactly equal to tax shield on interest.

This is the equilibrium level of debt, which maximizes the value of the firm. Excessive loans which must appear in the company balance sheet delivers bad message to investors. To minimize these effects, off-balance sheet financing

technique were adopted by many UK companies especially in 1980's with the intention to keep two levels of debts in their balance sheets. There are many alternative techniques of off-balance sheet financing adopted to lower gearing and consequently bankruptcy and financial distress costs. These techniques are not discussed in this work, but their effect is to lower finance cost through avoidance of premium. However, in a perfect market assumptions, the share price will include the information hidden from disclosure in company's financial statements.

CONCLUSION

Companies are operating on a going concern basis. They need to be in a position to maintain continuity by meeting daily operations while being able to meet daily financial and other commitments. Companies have a wide range of sources of finance. These include share capital, retentions and loan capital. Others have, in addition to the above, Government subsidy. Acquisition of finance takes place in a given financial environment. This function is greatly affected by the complexity and the level of the development of the financial system.

A well-developed system improves the manner in which the financing function is carried out. It is comprised of development banks, finance companies, bond markets, insurance and pension funds. These play an active role in the allocation of resources. As Kitchen (1986) argues, lack of a developed financial system restricts economic growth and Government policy should be directed towards encouraging growth of the financial system. Certainly, the financial system contributes towards economic developments in a number of ways as discussed earlier. Developed systems provide many sources and create scope for reducing finance costs. It is obvious that many developing countries have less developed financial systems. However, many are responding to the international pressures of competition, which make these countries uncompetitive. Emerging financial systems will meet country's needs for efficient services.

The global economic pressure has forced the financial sector in Tanzania to change. The extent of Government monopoly in the banking sector came to an end in July 1993 with the first introduction of private banks since nationalization in 1967.

More banks and financial intermediaries are due to be established in the future. Financial sector reforms will create flexibility, more accessibility and potential for cost reduction. It will also create competition leading to more efficient provision of services. The flexibility built in the system enables participants to get cheaper funds through extended short-term borrowing, which is cheaper than long-term. This is because short-term borrowers do not have to pay liquidity premium required by lenders for not getting their money immediately. In some cases, long-term borrowing may be cheaper than short term financing. This is so if fixed interest rate is adopted under high interest risks. This depends on the level of interest rates. Optimal borrowing will be determined to minimize the cost of capital, while investing the surplus fund to income generating projects.

Financial sector liberalisation should proceed in tandem with liberalization of other sectors. These include privatization of state enterprises and the open door policy meant to invite foreign investors to invest in Tanzania. For increased competition and the deregulation of interest rate ceilings, borrowers demand for finance will be met timely, and the establishment of equilibrium interest rate achieved (free from Government interference).

As in the UK competitive banking system, extra competition creates attractive margins. Low margins result from the fact that banks will have to lower margins in order to attract customers. Competition in banking sector means that funds are readily available and at attractive margins.

The Tanzanian financial system is slowly

getting the required discipline to match the global challenges. The government is also unable to sustain the system as a result of increased deficit and international pressures to address Government spending. The new system also comprise of the stock exchange and capital markets. These institutions have a source of finance for companies in Tanzania. Local and foreign investors have the opportunity to trade securities. It is also an avenue for investment by foreign investors who want to diversify internationally (Sharpe and Ross, 1978). The exchange controls have been abolished to enhance market operations, and the value of the currency has been floated. The existence of many sources of external finance costs through better margins as mentioned above.

However, not always are these changes beneficial. To benefit, especially in the market economy, the firm's value must convince investors that it is not threatening collapse, and that extra debt does not increase risks unnecessarily.

Tanzania should learn from creative accounting practices, which let down such promising empires as Polly Peck, Maxwell and Colorroll Plcs both of UK. As mentioned earlier, the objective of divesture is to relieve the Government of the burden of debt and losses of public enterprises. It will also ensure availability of technology and skills not available in the country. Access to foreign markets will be ensured while encouraging share ownership through equity investments by Tanzanians.

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