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Should The Government Buy Into Filoil ?

VICENTE B. VALDEPEÑAS, JR.

IT has been announced that the Government is interested in buying into Filoil and eventually financing its expansion. This interest stems from the laudable desire to restore Filipino control of the oil company,¹ but it must be evaluated in terms of its financial soundness. There are two reasons for this. First, it is basically a business proposition; second, it is an act of the Government and, therefore, should be of concern to citizens and taxpayers.

Much of what will be said in this article is based on data available from the financial statements of the Filoil Refinery Corporation at the Securities and Exchange Commission. Since 15 September of this year, a number of the principal local newspapers have published details of the Government interest in Filoil. There is little point in repeating most of them here. This article will consider whether the Government plan to buy into Filoil is financially sound or not, insofar as this can be determined from the financial reports of Filoil for the years 1969 and 1970.

Presumably, in this whole question, the Government's particular point of view is that of a prospective investor. An in-

¹ Initially, Filoil was owned and operated by Filipinos with considerable financial assistance from the Philippine government. After President Macapagal devalued the peso in 1962, financial pressures forced the Filipinos to sell the majority share of Filoil to Gulf Oil Company.

vestor in an industrial firm ordinarily requires that it have a comfortable margin of working capital. This frequently determines whether it can pay its debts, expand activities, and exploit opportunities for profit. It is the amount that remains free and clear after all of the current debts of a productive firm have been paid off. Thus, the working capital is the difference between the current assets and the current liabilities of a firm. In itself, the absolute peso value of this difference does not show whether the firm is in a reasonably comfortable financial condition or not. But when taken in relation to the current liabilities, a relationship shown as the current ratio, the working capital assumes meaning as a magnitude.

For most firms, minimum safety requires a current ratio of 2 to 1; that is, their current assets must be at least twice as large as their current liabilities. If this test were applied to Filoil in 1969 and 1970, it would have failed the test, as Table 1 shows. The current ratio of Filoil was 1.60 to 1, in 1969, and 1.65 to 1 in 1970. In effect, Filoil during either period had less than ₱2 in current assets for every ₱1 that it owed others and which must be paid within the year.

Table 1: FINANCIAL POSITION OF FILOIL

	1969	1970
	peso values in millions	
A. Current assets	₱ 74	₱104
B. Current liabilities	46	63
C. Inventories	17	26
D. Sales	105	134
E. Working Capital, A-B	28	41
F. Current ratio, A/B	1.60	1.65
G. Quick assets, A-C	57	78
H. Net quick assets, G-B	11	15
I. Quick assets ratio, G/B	1.24	1.24
J. Inventory turnover, D/C	6.17	5.15
K. Inventory — current ratio, C/A	0.23	0.25

Source: Filoil Refinery Corporation, *Balance Sheet*, December 31, 1970; and, *Statement of Income for the Year Ended December 31, 1970*.

As a matter of fact, if one were rigorous enough about testing the adequacy of Filoil's current position, he might examine its net quick assets position. The quick assets of a firm refer to that part of its current assets which are swiftly convertible into cash, excluding its merchandise inventories because these remain to be sold. Now its net quick assets are the difference between its quick assets and its current liabilities. For a fairly established industrial firm, this magnitude should amount to some 45 percent of all its quick assets or some 80 percent of its current liabilities, if it is to be reasonably comfortable financially. Once more, Table 1 indicates that the net quick assets of Filoil in 1969 amounted to 19 percent of all its quick assets or 24 percent of its current liabilities. In 1970, its situation showed no improvement, its net quick assets still amounting to 19 percent of its quick assets and 24 percent of its current liabilities and falling terribly short of the comfortable margin. In fact, Filoil's total quick assets both in 1969 and 1970 amounted to 1.24 per unit of its current liabilities. In effect, Filoil had available on the average about ₱1.24 in quick assets for every ₱1 of current liabilities. But, in general, a firm in reasonably comfortable financial situation would have a quick assets ratio in the neighborhood of 2 to 1.

To operate with lower current ratios would require that the firm hold a small inventory and promptly collect its accounts receivable. Just what constitutes an adequate inventory holding? This often depends on the type of business one has and of the time inventories are built up during the year. In the case of the oil refinery business, consumption of its products probably increases proportionately as people's income rises. Thus there is some presumption that prices of oil products tend to increase periodically under a given supply condition. If this is so, then one would not worry too much about holding a large inventory during the year since it can be sold periodically at increasing prices. On the supply side, the recent decisions of both the OPEC countries and shipping conferences in the world to raise their prices for crude oil and freight services would lead us to infer that the material inputs.

to the oil refinery business will be made available only at increasing prices. Thus, both demand and supply considerations would seem to suggest that a large rather than a small inventory should be maintained. Even so, there must be some way of telling whether the inventory one has is too large or just sufficiently large. This is indicated by the firm's rate of inventory turnover, or the frequency with which goods are bought and sold during the year. Thus, it is the ratio of sales to inventory. Generally, a ratio of 4 to 1 represents a workable inventory build-up, allowing an industrial firm enough time, in effect, to wait for better prices without being encumbered at the same time with unnecessary incremental cost for holding its actual inventory. The turnover of Filoil in 1969, as Table 1 shows, was 6.2 times and in 1970, 5.2 times. On the average, Filoil products were being bought and sold out more than five times per year. Whether this is financially sound practice or not is largely a matter of whether it accelerates the difference between incremental revenue and incremental costs. One can sell himself off the market by selling too much too soon, while incurring in the process too many costs too soon.

Regardless of the rate of inventory turnover, the proportion of inventory to current assets also indicates how large an inventory a firm should have. A workable percentage would be an inventory that amounts to 25 percent of total current assets, although different industries require different workable ratios. In the case of Filoil, nonetheless, its inventory in 1969 accounted for 23 percent of its current assets and in 1970, 25 percent.

From what has been said up to this point, it would seem that Filoil's financial position in recent years is somewhat ambiguous. Perhaps the ambiguity can be clarified by looking at the structure of Filoil's corporate finances, that is, the net book value or equity value of its securities.

To clear the way for such an examination, one should understand by book value the valuation at which something is carried on the books of a firm; in short, the value recorded in its balance sheet. Thus the net book value of any security,

bond, a preferred or common stock, indicates the amount of corporate assets supporting these securities. In general, the securities differ from one another in the degree of priority of claim over corporate assets, should the firm get liquidated for any reason whatsoever. Thus, the bondholder has more preferential liquidation right than the preferred-shareholder, both bondholder and preferred-shareholder more than the common-shareholder. Thus, bonds and preferred stock are senior securities, so that their coverage in terms of net book values means more than that for the common stock. If all the securities are to be covered adequately, the net book value per bond should be comfortably larger than that per share preferred, and the net book value per share preferred larger than that per share common.

In the case of Filoil, its long-term liabilities which operate much like bonds include those due to Gulf companies as well as its ordinary long-term debt. Data, such as those in Table 2,

Table 2: STRUCTURE OF FILOIL FINANCES

	peso values in millions	
	1969	1970
A. Long-term liabilities	P 64	P 87
B. Preferred stock	11	11
C. Common stock	22	22
D. Capital surplus	2	7
E. Accumulated retained earnings	6	7
F. Capitalization, $A + B + C + D + E$	105	129
G. Net book value per long-term liability, F/A	1.64	1.48
H. Net book value of preferred stock, $F-A$	41	42
I. Net book value per share preferred, H/B	3.72	3.81
J. Net book value of common stock, $F-A-B$	30	31
K. Net book value per share common, J/C	1.36	1.40
L. Long-term liabilities ratio, A/F	.609	.675
M. Preferred stock ratio, B/F	.105	.085
N. Common stock ratio, $(C + D + E)/F$.286	.240
O. Leverage factor, $(A + B)/C$	3.40	4.45
P. Long-term debt-equity ratio, $A/(B + C)$	1.93	2.63

Source: The same as Table 1.

tend to suggest that the relative spread in net book values between its long-term liabilities, preferred and common shares represents an uneasy coverage. While it is true that book values cannot be overemphasized, since often profitable firms that indicate low book values have substantial earnings and book values can and do diverge from the market prices of securities, nonetheless, over a number of years, they tell us whether the firm is expanding or contracting. On the average, for Filoil in 1969 and 1970, the net book value per long-term liability was ₱1.55, per share preferred ₱3.76, and per share common ₱1.38. It is difficult to say from these magnitudes whether Filoil is gaining or losing ground.

As a matter of fact, a prospective investor in Filoil might question the structure of its capitalization. What proportion of its financing or capitalization is contributed by long-term debt, such as bonds; what proportion by preferred and common stocks? This is a matter of its capitalization ratios, where capitalization refers to the face value of its long-term debt and the par value of its stocks, face and par values meaning the nominal value of securities. In general, a firm that depends mightily on long-term debt for its finances could discourage subscription to its preferred and common stocks. For that matter, it could discourage subscription to its common stock if it relies heavily on preferred stocks for financing. This is because payment of interest on the long-term debt precedes any payment of dividends on the preferred stock, and dividends on the preferred precedes any payment of dividends on the common stock.

Insofar as 1969 and 1970 went, Table 2 shows that, on the average, 64 percent of Filoil's capitalization was generated out of its long-term debt, 9.5 percent out of preferred stock subscription. In this accounting, the capital surplus which is the amount paid by stockholders in excess of the nominal value of the common stock, and the accumulated retained earnings which represent undistributed corporate profits reinvested to support Filoil's expansion are both added to the common stock subscription because they are effectively backing it.

As a general guideline, no more than 25 percent of an industrial firm's capitalization should be raised from long-term debt and the proportion contributed by common stock should be at least equal to the proportion contributed both by long-term debt and preferred stock subscription. Following this guideline, Filoil's structure of corporate finances as constituted at present is undesirable. Its almost visceral dependence on long-term debt is not likely to help it raise new capital. Banks seldom lend their resources to firms ridden with enormous debts, while investors get dismayed by the interest burden of such debts to the point of avoiding subscription to their common stock. As a matter of fact, between 1969 and 1970, Filoil's long-term debt-to-equity ratio rose around 36 percent from ₱1.93 at ₱2.63. This may mean an increasing leverage factor which might be a good thing so long as its rate of earnings rises. But it certainly implies that interest cost expands proportionately, and if the earnings rate goes down, the firm would be compelled to dip into its accumulated retained earnings to meet its interest payments, since its high leverage position means that long-term debt and preferred stock subscription constitute the bulk of its capitalization. Such a situation may seem attractive to professional speculators but hardly encouraging to serious investors, whose principal concerns are the safety of their investment and the regularity of its yield.

Indeed, the net profit ratio of Filoil decreased from 1.3 to 1.1 percent between 1969 and 1970, as Table 3 shows. This is because, although its sales expanded some 27 percent, its operational costs rose by 28 percent; that is, costs increased proportionately faster than revenue. The analysis can be pursued a step further by examining its rate of return on capital, which is about the most common index of a firm's performance. In estimating Filoil's capital, one must include the financial resources extended by Gulf companies and the other long-term debts which, together with stockholders' equity, effectively support the capital base of Filoil. As Table 2 has shown, total capitalization of Filoil in 1969 amounted to ₱105 million and in 1970, ₱129 million. Table 3 shows that its gross profit for

the same period was ₱3 million per year, while its net profit in 1969 totaled ₱1.4 million and in 1970, ₱1.5 million. Thus, both its gross and net rates of return on capital receded between the two dates, from 2.85 to 2.32 percent in the case of the gross rate and from 1.35 to 1.16 percent in the case of the

Table 3: EARNINGS OF FILOIL

	1969	1970
	peso values in millions	
A. Sales and other revenues	₱105	₱134
B. Cost of sales & other charges	102	131
C. Gross profit, A-B	3	3
D. Interest on preferred shares	.8	.8
E. Provision for corporate profit tax	.8	.7
F. Net profit, C-D-E	1.4	1.5
G. Gross profit ratio, C/A	.0286	.0224
H. Cost ratio, B/A	.9714	.9776
I. Net profit ratio, F/A	.0133	.0111
J. Interest coverage rate, C/D	3.75	3.75
K. Dividend requirement for preferred stock	.8	.8
L. Preferred dividend coverage rate, F/K	1.75	1.87
M. Earnings available for common stock, F-K	.6	.7
N. Number of shares of common outstanding, million	22	22
O. Earnings per common share, M/N	0.027	0.032
P. Undistributed earnings	1	1
Q. Market price per share common	1.09	1.09
R. Price-earnings ratio, Q/O	40.37	34.62
S. Depreciation	32	42
T. Cash flow, F+S	33.4	43.5
U. Cash flow per share common, T/N	1.51	1.98

Source: The same as Table 1.

net rate of return on capital. The principal explanation for this decrease in the earnings rate was Filoil's increasing appetite for long-term debt, from both its mother Gulf companies and its other sources. In effect, the interest burden on these debts is beginning to strain Filoil's capacities. And the fact that its operating margins of profit, in gross or net terms, are actually decreasing suggests that its resources are not being used as well as they might be in the production or distribution aspects

of its total operations, or in both. The low values of the profit margins in themselves do not give much ground for optimism.

This leads to a final consideration: whether Filoil at this point in its corporate history is a good buy for the Government or not. A private investor can be somewhat reckless about his money, because if he loses on it, he can always console himself in the fact that it was after all his own money. That is, he will be the sole privy to the fruits of his own recklessness. The case of the Government as investor, however, is entirely different. What it invests are, in the final analysis, public savings, however these are generated. If these arise from taxing its constituents, through conventional taxation, such as the BIR revenue, or the unconventional methods, such as GSIS and SSS contributions, the public savings that emerge thereby can be said to represent blood money. If there are any investable funds that must be anxiously economized, it is blood money because it takes so much out of a people's life. Should their investment turn out to be unprofitable, its retrieval will require more blood money from the present and possibly the forthcoming generations of Filipino taxpayers, until the last centavo of amortization will have been paid off. No good government bleeds its people to this extent.

If our Government is good and anxiously wants to avoid such a possibility, then, in its plan to buy into Filoil, it must behave as most earnest investors, rather than as a frivolous speculator. There are two very important considerations to an investor. One is the soundness of the investment, and the other is the regularity of its yield. His concern about the rate of return on his capital is secondary to his concern about its safety and the periodicity of its earnings, since ordinarily increasing income also involves accelerating risks, so that one must trade off regularity and safety of earnings for a moderate income.

The safety of any investment depends principally on its earnings, since these determine what is available for interest payment on outside funds and dividend payments on stockholders' equity. Even if it is true that a long-term debt takes

a long time to pay off, the interest on it is a current fixed cost insofar as the daily operations of a firm are concerned. Hence, it is terribly crucial that its use of debt generate enough earnings not only to support its strictly operational costs, but also to leave an adequate margin to pay off the interest cost for the period and still have something left over for dividend payments eventually.

Thus the investor must look into the firm's interest coverage ratio, which is a relationship between its gross income before interest and tax requirements, and the interest on its long-term debt. Generally, a minimum coverage ratio would require that such interest commitment be earned three to four times over. In the case of Filoil, its interest coverage ratio was 3.75 per year both in 1969 and 1970, and the coverage is limited to interest only on preferred shares. Thus, insofar as this goes, one can say that Filoil does meet the minimum margin of safety, although it probably is not a fair, much less a comfortable, margin of safety. If it were possible to equate what SyCip, Gorres, Velayo & Co., the auditing firm for Filoil's financial accounts, describes equivocally as "other charges" with interest cost on long-term debt, then even its minimum margin of safety might well degenerate into a precarious margin.

When one further considers Filoil's preferred dividend coverage, or the number of times preferred dividends have been earned, the data in Table 3 show that, on the average, it has earned its preferred dividend requirements less than two times, certainly much less than it has earned its (limited) interest cost and a more questionable margin of safety. The same table shows that Filoil's earnings per share of its common stock averaged barely three centavos per year. This magnitude in itself is scarcely encouraging to a prospective buyer of common stocks, who frequently is not as interested in dividends as in the earnings available per share of common stock, which generally also determines stock market prices.

Thus far, the conclusion that seems to emerge from all this is that the Filoil securities are not as safe as one might want them to be.

Whether it is still good to invest in Filoil even as its securities are somewhat risky is a matter that depends on other considerations. One might consider, for example, the relationship between its earnings per share common and the market price at which a common share sells, or what is known as its price-earnings ratio, since this partly determines fluctuations in the price and the return on common stock, either for a given firm over a number of years or for different firms at a point in time. Our data in Table 3 show that Filoil's price-earnings ratio has receded from 40.4 in 1969 down to 34.6 in 1970, even as it is true that its common shares are selling on the average at $37\frac{1}{2}$ times their earnings. Finally, insofar as its total cash flows for the same period are concerned, that is, the sum of its net profit and depreciation allowances, they increased from ₱33.4 million to ₱43.5 million between 1969 and 1970. But this is principally the result of accelerating its rate of depreciating or writing off its investment in fixed assets, a purely internal arrangement. Thus, even as the cash flow available per share common increased from ₱1.51 to ₱1.98, the gain appears to arise, not so much from the vigor of its operations, as from the apparent languor of its productive capacity.

In conclusion, the weight of the evidence available from its financial accounts in recent years tends to show that Filoil, as a corporate structure independent accounting-wise from its maternal Gulf origins, is languishing financially. One wonders whether it is a likely entity in which to invest a people's blood money, as the Government is anticipating to do.² It is true, of course, that the sheer prospect of some blood transfusion can invigorate a person. Now this is a useful thing to do, so long as the benefaction goes to those who need it and are likely to spread it around some hundredfold hopefully. However, the impression remains that around 62 percent of Filoil's present equity is controlled by mother Gulf, the other 38 percent being

² It is possible to argue the case that Government participation should be limited to financial assistance. However, if one can go by the history of Government participation in industry, inevitably the Government grows into effective control of company operations, an eventuality that one may foresee as the beginning of the end of Filoil.

a token to Filipinos. If that is so, then, in effect, the Government move to buy into Filoil might be more of a relief to uneasy mother Gulf than a restoration of Filipino control over its languid financial structure. Ordinarily, it is charitable institutions that come to the succor of languishing persons. Perhaps our Government is a charitable institution, although in the present case its charity is probably misplaced.