The National Industries Group (NI): A Case Study

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This case was prepared by Turki Alshimmiri, Finance Department, Kuwait University as the basis for class discussion rather than to illustrate either effective or ineffective handling of administrative situation.

Introduction

National Industries Group (NI) is a well established multinational holding company located in Kuwait. Recently, NI has followed aggressive diversification strategy which was aimed to establish a much diversified industrial asset portfolio in a pre-established plan to outsource its income. Its operations now extend from Pakistan in the east to Morocco on the west. NI also has many enriched markets through many subsidiaries in Europe and North America. Meed Money magazine has ranked NI as the second largest publicly quoted industrial firm in the Middle East. NI enjoys a very ambitious administration with high level of expertise as they look for expanding the horizon of the company's operations into other diverse industries. NI is still following its strategy of diversification into different industries keeping its limits into only interrelated portfolio of assets. NI now focuses on allocating 70% of its industrial investments in Kuwait and the GCC countries and 30% in other Arab and foreign countries.

As NI begun to rapidly diversify its asset portfolio through acquiring many firms in distinct markets, NI managers are now considering new financing options for their expansion plans. NI management is reviewing a request by the treasurer of NI to issue new KD 35-million bonds to replace the old issue that matures at the end of 2001. The treasurer thinks that issuing debt instead of equity is an appropriate alternative given that NI currently has a good credit standing (which is BBB) and also the interest rates level in Kuwait is relatively low (see table II). The scope of the discussion among board members now would have a major impact on the rearrangement of NI's capital structure.

History

The National Industries Company (NIC) was incorporated in 1960 as it was established mainly to be a joint public-private sector project that could function as part of a private sector to promote industrialization projects in Kuwait which became independent in 1961. NIC started its business in construction as its preliminary duty was to operate two established factories (one producing cement-based products and the other limestone and bricks) and to develop the building materials industry in the country.

During its history, NIC had a major contribution to the industrialization wave in Kuwait through its role in founding several firms that have been leaders in their markets. These firms include Kuwait Building & Construction Co., Kuwait Metal Pipes Industries & Oil Services Co., and Kuwait Cement Co. During 1970s, NIC has expanded considerably especially after establishing two factory complexes which both expanded the production capacity of NIC to unparalleled level. After some market conditions changed and as competition started to become more intense, NIC management has adopted new strategy by which it has extended 1ts portfolio focus to comprise more consumer industries such as Persil and Dixan washing powders (licensed from Henkel, Germany) as well as setting up automobile battery factory. NICs business also extended regionally to incorporate founding three firms in the GCC countries (in Saudi Arabia and United Arab Emirates). By l980s, NIC became a well recognized conglomerate firm with relatively high production capacity and wider markets.

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NI Group

In 1995, NIC's board of directors had made a strategy by splitting-up the company into a group of independent and specialized companies in different business segments. In 1997, the National Industries Group (NI) was established as a holding company with a main goal of establishing new ventures. As a way to strengthen its position in the market, NI has made significant investments in leading industrial firms in Kuwaiti and GCC countries. These companies are:

(1) Kuwait Cement Company: Listed in Kuwait stock exchange, this company specializes in providing NI with various types of cement with an annual production capacity of more than 200,000 MT of grey cement and 75,000 MT of white cement. The company has plans of doubling its production and adding a new line of clinker with a starting production capacity of 1,000,000 MT. According to year 2000 annual report Kuwait Cement Company has increased its production by 22% over the previous year. NI owns about 23% in this company.

(2) Kuwait Building Materials Manufacturing Company: Although a private shareholding entity, this company has increased its sales by more than 20% in year 2000. This substantial increase pushed the general assembly of the firm to submit an application for listing in Kuwait stock exchange after meeting all the requirements set by the authorities. NI owns about 31% of this company.

(3) Kuwait Financial Center: In spite of the stagnation in the financial markets in year 2000, this company succeeded to increase its profits due to its diversification of its investment and banking services as well as the sale of more than 50% of the "Casa Mishref', a housing project owned by the company. NI owns about 13 % of this company.

(4) National Investment Company: This Company has investments in different business sectors in the form of both real and financial assets. In year 2000, 11

Competitive Environment

Kuwait is a single producer country with the main source of income coming from oil. In such an economy, the driving force that stimulates economic activities is the government expenditures. Since its independence, Kuwait government has established many firms as a way to promote private investments, outsource national income, and to strengthen the private sector in order to perform its vital role in the economy. NIC, which became NI, was one of those firms. Being the only national firm in the field of construction, most government contracts with the private sector require using NIC products. That is, whoever wins tenders from government was obliged to use most construction materials from NIC. For this reason, one can notice that NIC development was inextricably linked with the economic growth of Kuwait. This competitive advantage has dominated the way NIC conducts its business given that about 85% of its sales were to government projects. Nevertheless, NIC was never been a government-spoiled child, but rather, during its history, NIC has been innovative in its products which were characterized by being suitable to the special weather of Kuwait, especially its famous limestone, the aerated concrete, interlocking blocks, curbstones, and plastic pipes. During seventies, there was high demand for NIC products due to the elevated increase in government expenditures especially housing projects which mainly used construction materials from NIC products. By and large, with the help of government, NIC became the premier industrial company in Kuwait outside the oil

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industry with continued investment in automation and modern computerized production technology in world class factories.
After the destruction that Kuwait suffered to its infrastructure during the Iraqi invasion to Kuwait, two important factors have affected NIC competitive advantage, profitability, and hence strategy. First, the dwindling government expenditures which were due mainly to the prevailing decline in oil the price. Second, the many private national firms (who mainly import all their construction materials from abroad) that have emerged and entered the construction market and posed a severe competition to NIC since Kuwait construction market is relatively a small market. Consequently, NIC has lost its advantage in ensuring government contracts as the government no more gives priority to any product from any firm but rather require some standard specifications. As a result, NI management has seriously sought to diversify its income instead of depending on government support. In November 1995, NIC has put a new strategy by which NIC becomes in 1997 a holding multi-industrial company that concentrates its 70% of its investments in local and regional markets while 30% in international markets. The current competition comes from many local private firms especially the "Habel" brick (a new technology in construction produced by Alkhaled group) which is the main competitor to the famous limestone brick of NI. Also, the regional and the international competition come from many established multinational firms which use different technological advancement in construction business. That's why NI managers pushed towards diversifying NI activities.

Capital Structure and Investment

Through its recent history, NI has financed its ambitious diversification programs by different modes of financing. NI management was keen to restore its financial flexibility whenever possible. For example, NI has issued a KD 35 million 3-year unsecured bonds with coupon rate of 7.875%, and due to its strong financial position, NI was able to service the debt promptly. Although the financing policy of NI has always been based on maximizing financial flexibility as NI enjoys diversified business portfolio, the debt level of NI was always higher than that of its competitors in the same industry group in Kuwait. In framing its debt policy, NI's managers' key concern has been always the riskiness of the business. NI management is aware that diversification can reduce its business risk as the dependence will be on more than one source of income.
NI management believes that the financing policy is more complex than simply structuring an optimal mix of debt and equity. Other variables have also to be considered. The ability to carry certain amount of debt is not determined only by absolute amount of debt but also by the magnitude of the periodic cash payments. Also, creditor's rights against liens of assets have to be considered as well. Even if NI wants to carry more debt, managers are concerned about how to plan for the source of financing; that is, whether to issue bonds or to obtain private borrowing from banks. The average debt ratio of NI over the last five years (1996-2000) is above 55% while it was about 38% for the industrial sector in Kuwait. In addition, the average interest expense (as a percentage of sales) over the period of 1996-2000 is 14.4% for NI while the industry standard is only 6% for the same period. The stock price has declined since the firm restructured its activities and became a holding company in 1997.

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Sectional Analysis

NI is the oldest industrial firm established in Kuwait as it has been in business for at least 39 years. In year 2000, the market capitalization was the highest as it was amounted to KD 188,105 million (about $ 620,747 million). The firm also enjoyed the highest funds from operations in year 2000 as these amounted to KD 7,533 million (about $ 24, 859 million). The firm also is the biggest in its sector in terms of the asset size as its assets in year 2000 amounted to KD 336,692 million while it is KD 98,481 million for the next company in line. The average (during 1996-2000) of both the market to book ratio (2.1 times versus 2.6 times for the industry) and the PE ratio (13.9 times versus 21.3 times for the industry) are below the industry standard. Similarly, the dividend yield is also below that of competitors' over the years 1996- 2000 (2.29% versus 2.5 1% for the industry). However, NI enjoys a better profitability than its competitors. NI's average (1996-2000) net profit margin is about 30% while it is about 26% for competitors for the same period. Likewise, the average ROE over the same period is about 16% for NI while it is about 13% for the industry. However, as NI's strategy is to gain bigger market share, they might experience a period of low profitability in later years. If so, they can not commit themselves to large cash payments especially to shareholders. High amount of debt also causes NI secrecy to be infringed as they have to publish the intended use of the borrowed money.

The Current Situation

NI now is facing a promising future of profitable investments. NI managers are a ware of the fact that restructuring the firm into a holding company and indulge into managers endeavors in developing firm activities needs a lot of financial resources that needs to be collected from different sources. The new strategy of NI calls for collecting about one billion US dollar within five years starting from 1998. Based upon the new focus of NI many strategic challenges appear to be under way. One of these is the capital structure of the new company. As mentioned earlier, the amount of debt is already above the customarily level relative to the industrial sector in Kuwait. One of the main concerns for NI mangers is the future financial flexibility so as to enable NI to achieve the proposed plans. On the whole, NI managers want the financing decisions to follow the company's new strategic plans. So, NI managers have to choose the financing method that would have the most auspicious impact on the company's value.

NI now is thinking of raising additional financing (about KD 35 million) to be used for financing new projects. Mainly, the new funding will be spent on renewing some old assets (factories) in Kuwait. Managers are thinking to use more debt by issuing new bond to replace the current bonds which mature this year (year 2001).

In addition to the financial concern, the recent restructuring of NIC to be a holding firm that acquire as many companies as possible in order to be more profitable in highly competitive markets is another concern for the management since managers are responsible in front of shareholders to escalate the stock price as much as possible in order to increase shareholders wealth. Now, NI management is seriously considering issuing new bonds to function as a carry over to the existing bond issue which matures at the end of this year (year 2001). NI managers think that the interest rates are at their lowest levels as Kuwait central bank has already lowered its discount rate so as to shorten the gap between US rates (as well as most industrial countries) and Kuwaiti interest rates.

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Appendix

Table I: Comparative Balance Sheet for NI for the period 1996 – 2000

	1996	1997	1998	1999	2000
Cash	22.942	6.011	11.945	19.13	15.107
Receivables	5.091	24.933	42.426	29.302	27.725
ST Investments	102.128	145.28	113.389	99.492	98.223
Inventory	8.448	7.663	25.787	19.164	18.364
Current Assets	138.609	183.887	193.547	167.088	159.419
LT Investments	51.382	71.021	61.81	24.775	32.631
Fixed Assets	11.016	5.963	38.476	24.775	32.631
Other Assets	0	0	65.061	36.944	33.277
Total Assets	201.007	260.871	358.894	329.935	336.692
Payables	7.273	9.448	32.501	23.06	19.755
Bank Credit	56.723	97.232	70.557	112.56	119.146
Other Liabilities	10.478	19.699	0	0	35
Current Liabilities	74.474	126.379	103.058	135.62	173.901
LT Liabilities	8.936	6.535	122.554	55.514	20.736
Liabilities	83.41	132.914	225.612	191.134	194.637
Paid in Capital	41.913	50.295	55.325	55.325	55.325
Treasury Stocks	0	0	(1.892)	(2.57)	(2.758)
Reserves	64.127	67.145	68.623	69.035	64.538
Retained Earning	11.557	10.517	11.226	17.011	24.95
Share Equity	117.597	127.657	133.282	138.801	142.055
Liability & Share Equity	201.007	260.871	358.894	329.935	336.692

Note: Figures are in Million KD.

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Table II: Sectional Analysis for the years 1999 – 2000 for NI and other industrial firms in Kuwait

Company	Assets		Equity		Sales		OP		NI	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
NI	330	336.7	138.8	142.1	84.9	83.8	6.8	7.5	16.8	16.5
2	15.9	27.4	11.6	18.4	13.1	19.6	2.3	3.5	2.2	3.1
3	38.7	40.1	12.3	12.9	4.5	7.3	.016	.84	.52	.69
4	20.4	25.6	12.3	51	19.1	19.8	5.4	5.1	11.5	11.5
5	64.8	65.2	48.9	51	19.1	19.8	5.4	5.1	11.5	11.5
6	77.4	94.6	68.5	72.6	17.1	17.4	2.8	1.3	2.3	3.2
7	6.4	7	5.7	6.1	1.4	1.9	.61	.84	.95	1.3
8	4.8	5.3	4.1	4.7	1	1	.05	.2	.23	.78
9	40.8	41.1	21.5	24.7	.05	2.3	-.1	-.5	1.4	3.2
10	31.4	31.2	25.6	25.5	15.9	13.6	3.5	2.3	5.1	4.4
11	32.9	336.7	138.8	142.1	84.9	83.8	6.8	7.5	16.8	16.5
12	4.3	6.5	2.9	4	2.9	4.1	.2	.4	-1.3	1.4
13	105.9	98.5	96.9	86.5	30.8	.4	8.6	5.4	11.7	3.7
14	7.8	8.4	5.6	5.5	5.6	7.4	1.7	1.2	1.5	.94
15	4.5	4.9	3.7	4.1	3.4	3.3	.23	.01	.38	1.17

- Figures are in Millions.
- Source: Investors' Index, 3rd ed, Money and Real Estate Magazine.
- OP: Operating profit
- NI: Net Income

Table III: Financial Ratios for NI over the period 1996 - 2000

	1996	1997	1998	1999	2000
Liquidity Position					
Current Ratio	1.9	1.5	1.9	1.2	.9
Working Capital (millions)	64.14	57.51	90.49	31.47	-14.48
Activity Position					
Asset Turnover	.1	.1	.4	.3	.2
Inventory Turnover	1.2	1.6	3.7	3.4	3.5
Days Sales Outstanding	106	480	117	124	119
Profitability					
Operating Profit Margin	12%	19%	13%	8%	9%
Return on Assets	14%	13%	4%	5%	5%
Return on Equity	22%	25%	10%	12%	12%
Dividend Payout Ratio	44%	17%	62%	49%	0

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Table IV: Additional Financial Data

Company	Beta	Debt Ratio	M/B	DY	PE Ratio	EPS
NI	1.14	58%	1.3	0	11.4	30
2	1.24	40%	1	9.15%	7.5	22
3	1.01	23.3%	.8	0	18.6	8.5
4	.93	13.3%	1.5	7%	12.9	34.4
5	.48	22%	2.2	8%	10	180
6	1.18	37%	.7	0	18.7	5.9
7	.88	50%	1.6	0	31.6	9
8	1.25	19%	2.1	8%	13	58
9	1.18	39%	2	3%	5.4	66.3
10	1.14	11.5%	.8	34%	5.1	37.2
11	1.15	13%	1.8	9%	9.2	80.4
12	1.23	33%	1.9	8%	9.5	41
13	1.75	12%	.6	0	14.9	4.7
14	1.75	18%	1.5	0	65.4	2.6
15	.93	17%	1.2	10%	4.5	44.7
16	.45	34%	3.4	5.3%	21	28

- Source: Investors' Index, 3rd ed., Money and Real Estate Magazine.
- All data are based on year 2000 financial statements.
- Debt Ratio: Total Debt/ Assets
- M/B: Market to book value of the stock
- DY: Dividend Yield
- PE Ratio: Price /Earning
- EPS: Earning per share (in fils)
- According to the statistics issued by the Central bank of Kuwait, the average of the short term government bond rate is about 5.5%.
- The market risk premium according to calculations by Global Investment House is about 7.25%.

Table V: NI Borrowing for the Period 1999 – 2000

Panel (a) Short-Term Borrowing (in KD)

	Interest Rate	Security	Year 1999	Year 2000
Kuwaiti Dinar	6.8% – 8.25%	Unsecured	56,725,000	63,725,000
US Dollars	6.5% – 7.75%	Unsecured	16,815,000	16,801,000
Euro	4.5% – 5.5%	Unsecured	3,142,000	2,897,000
Sterling Pound	5.5% – 7.2%	Unsecured	23,328,000	16,044,000
Deutsche Marks	5.55%	Secured		102,000
		Totals	100,010,000	99,569,000

Panel (b) Short-Term Borrowing (in KD)

US Dollars	6.5% – 7%	Unsecured	10,501,000	
US Senior Notes	8.75	Unsecured	10,664,000	
Deutsche Marks	5.55%	Secured		662,000

- All loans mature within 5 years (from year 2000).
- Deutsche Marks loan is secured against German properties with a book value of KD 641,000.

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Discussion Questions

1. Why NI managers want to increase their usage of debt?
2. What are the advantages of using debt financing over other alternatives?
3. Has NI reached its full debt capacity? Its optimal debt level?
4. What is the essence of the long term financial health and solvency?
5. What is the impact of inflation on financing needs?
6. How cost of debt is calculated? If there are no taxes in Kuwait, what is the attractiveness of debt issuance? That is, how one can justify using debt financing?
7. What is the debt coverage ratio and how it is used in making a decision for the new proposed debt financing?
8. How one can tell if a debt level is reasonable for a firm in certain industry?