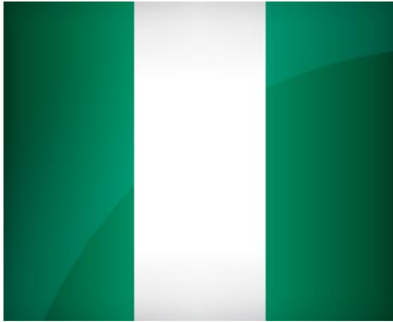

Consultation Paper on Determination of Capital Structure for Licensees in the Communications Sector in Nigeria

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Glossary of Terms and Abbreviations

IDA – International Data Access Licence

Interconnect - means that different carrier's networks are connected to allow mutual traffic

ISP – Internet Service Provision Licence

RoE – Return on Equity

RoI – Return on Investment

S&I – Sales and Installation Licence

TR – Technical Review

UASL – Universal Access Service Licence

VAS – Value Added Service

1.0 Preamble

The Nigerian Communications Commission (the Commission) is established by Section 3 of the Nigerian Communications Act, 2003 ("Act") with the sole responsibility of regulating the Nigerian communications sector. The Act in Section 4 (1) also outlines the functions of the Commission to include, inter alia, the facilitation of investments in the Nigerian communications market and promotion of fair competition amongst its licensees. Importantly, the Act also places the general responsibility for economic and technical regulation of the communications sector on the Commission. Hence, the Commission aims to protect the Industry, sustain the market structure and establish benchmarks that will ensure fair competition.

Consequently, the Commission is desirous of reviewing the financial performances of its licensees and setting parameters that will determine the sanctity of investments, liquidity in operational funding and ensure sustainability of the Industry. This desire is hinged on the recent challenges in the sector and possible impacts on the health and capacity of the market, particularly in the light of dwindling revenue and widespread operational challenges. These planned parameters will be based on determination of an ideal capital structure for each category of licensees and a monitoring mechanism that will ensure that a fair and stable market structure is sustained in Nigeria.

Capital structure, for this purpose, refers to the amount of debt and/or equity employed by a licensee to fund its operations and finance its assets. This capital structure is typically expressed as a debt-to-equity or debt-to-capital ratio. More so debt and equity capital are used to fund a business's operations, capital expenditures, acquisitions, and other investments. The Commission intends to set out an optimal capital structure for its licensees, as the proportion of debt and equity that results in the lowest weighted average cost of capital. In order to optimize its capital structure, a licensee can issue either more debt or equity and the new capital that is acquired may be used to invest in new assets/infrastructure or may be used to repurchase debt/equity that is currently outstanding, as a form of recapitalization.

Although there are many contextual issues in relation to determination of capital structures, the Commission is focused on investments, shareholders' funding and the ratio of debt to equity of all its licensees. Thus, capital structure in this context refers to the proportions or combinations of equity share capital, preference share capital, debentures, long-term loans, retained earnings and other long-term sources of funds in the total amount of capital which a licensee should raise to run its business. The word 'equity' denotes the ownership of the company, while trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It also refers

to the additional profits that equity shares earn because of funds raised by issuing other forms of securities, viz., preference shares and debentures.

Capital structures can vary significantly by industry and the Commission is conscious of that and will build a sector-specific approach that takes into account the different licensing categories and the capital intensive nature of communications services. Unfortunately, there is no standard ratio of debt to equity to use as guidance. What defines a healthy blend of debt and equity varies according to the industries involved, line of business and a licensee's stage of development. However, because investors are better off putting their money into companies with strong balance sheets, it makes sense that the optimal balance generally should reflect lower levels of debt and higher levels of equity.

In the light of this desire and conscious of its powers in Section 70 of the Act to make regulations and guidelines, the Commission is initiating a consultation process that will facilitate a regulatory rule-making process as prescribed by Section 71. This process will evaluate the current status of licensees, the approaches in other jurisdictions and the Commission's key obligation to sustain the market structure. It is the hope of the Commission that this process will ignite more discussions on the financial and investment health of licensees and possibly develop a long-lasting approach that will create a fair and stable communications sector in Nigeria.

2.0 Introduction

The communications sector, which includes data communication, is experiencing massive growth and expansion all over the world. This rapid expansion is due to the rapid technological advancement and adoption of technology in many functions both at the corporate and individual level. Due to this, many opportunities have risen in this industry leading to increased competition and the need for improved efficiency to remain competitive in the industry. One of the ways that a licensee can enhance its competitive advantage is by adopting an optimal capital structure. Establishing an optimal capital structure is one of the critical decisions that the managers of an organization have to make.

Capital structure depicts the manner in which a licensee finances its operations and growth by using different sources of funds, the two major sources of finance are debt and equity. Debt can be in the form of long-term loans, bonds and long-term notes payable, while equity is in the form of retained earnings, preferred stock and common stock. Therefore, capital structure is the mix of different securities used in financing a firm's investment and each of these sources of finance is associated with different levels of risk, return and control. Licensees can use either debt, equity or both to finance their operations and in the balance sheet, the capital structure is represented as the ratio of debt instruments, common stock and preferred stock. Yet, a key part of this is that company structure involves making a decision on the proportion of equity and debt a firm uses to finance is operations. Another key part also involves a decision on the level of long-term to short-term debt that a firm uses to finance its operations.

The Commission's desire is to derive an optimal capital structure that will become a financial framework, which depicts how equity and debts are utilized in financing operations of its licensees and serve as a central pillar to the achievement of a stable communications sector in Nigeria. This desire is hinged on review of the level of risk, returns and the associated cost of capital. A licensee without adequate capital is at a possible perilous situation and there is thus a need for the determination of its capital in advance, as the capital structure of a licensee determines the overall proportion of debt and equity that is employed in financing its operation and keeping it afloat.

There is also the issue of liquidity in the sector, which will ensure deployment of more services, facilities and assets. Liquidity is the ability of a licensee to meet its daily financial obligations as the liquid resources of a licensee are used in financing their daily business operations and thus it is central to the sustainability of its activities. The liquidity need of a licensee may also affect its choice of capital. Licensees that use more of equity in financing their operations tend to enjoy high degree of liquidity because

debt requires payment of principal and interest from the licensees' liquidity which will affect adversely liquidity position. In the case of equity, the retained earnings and proceed from ordinary shares can be used in financing licensees' operation for long period of time without the payment of principal, what the shareholders expect is the residual profit in terms of dividend. On the other hand, the ability of a licensee to sustain optimum liquidity makes it to attract more debts when there is financial deficit when the growth and investment opportunities are higher than retained earnings. The lenders consider licensees that can sustain optimum liquidity for a long period of time because it signals that they will be able to meet up with the payment of interest and principal when they are due.

The Commission recently conducted a review of the financial health of its licensees as a fallout from the systematic crisis faced by some of them, mostly associated with huge indebtedness and huge deficits in shareholders' funds. The outcome of the review raised concerns and accentuated the widespread issues on capital structures and unsustainable debt to equity ratios of a substantial number of the licensees. This requires a mechanism that will pre-emptily set parameters and monitor compliance; this is both imperative and a necessity that will protect the market.

3.0 Current Capital Structure of Licensees in the Communications Sector

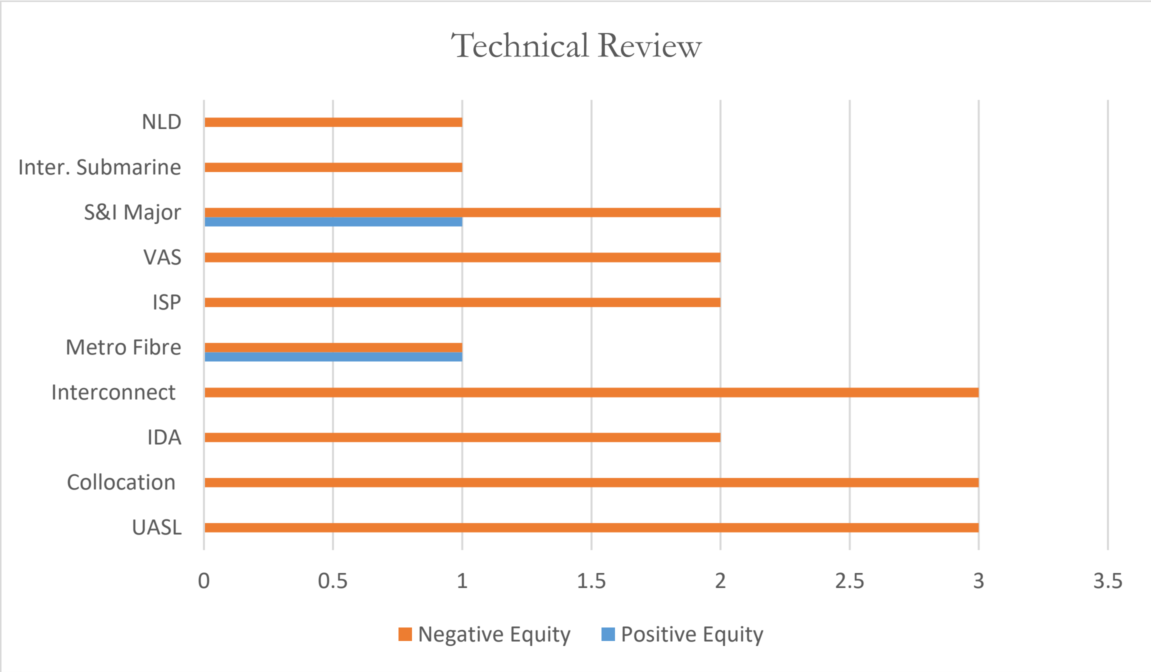
The Commission set up a Committee in March 2020 to review the existing capital structure in the Sector and determine whether there is a need to set any benchmarks or parameters. The Committee conducted a Technical Review (TR) of a sampled population of current licensees, cutting across fifteen (15) licensing categories.

A surmised presentation of the TR is captured in the table below:

Licensing Category	Sample Size	Licensees with Positive Debt-to-Equity Ratio	Licensees with Negative Debt-to-Equity Ratio
UASL	3	0	3
Collocation	3	0	3
IDA	2	0	2
Interconnect	3	0	3
Metro Fibre	2	1	1
ISP	2	0	2
VAS	2	0	2
S&I Major	3	1	2

International Submarine	1	0	1
National Long Distance	1	0	1

This is better captured in the chart format below:



It is clear from the outcome of the TR that the Commission needs to act in a timely manner, to forestall a systematic and sector-wide collapse and its possible impact on the economy and national security of Nigeria. Clearly the outcome of the TR of the sampled licensees supports the need for a consultation process that will facilitate a determination of an ideal capital structure that will protect and sustain the communications sector in Nigeria.

4.0 The Premise for the Determination of Capital Structures in the Communications Sector

There are many premises for determination of capital structure of licensees of the Commission, this is as envisaged by Section 4 (q) of the Nigerian Communications Act 2003. First, such determination will ensure the market stays stable and fairly competitive with tangible assets that provide both liquidity and sustainability. Tangibility in this

context refers to the durable noncurrent asset of a Licensee. The tangible assets can serve as collateral and thus can be used by a licensee in obtaining long term debt. This implies that a licensee with tangible asset can utilize more of debt in its capital structure because the tangible asset will serve as collateral for the security of the loan. This has made it very easy for tangible firms to access long-term debt as against firms with low tangible assets. Thus, this is a key premise for the Commission to set parameters for the sector.

The second premise is that a high degree of liquidity implies a lower degree of debt. An optimal level of liquidity presumes less requirement for borrowing and external funds. Based on this premise the licensees should ensure an optimal level of liquidity in order to fulfil their engagement and the Commission will be conscious of the sizes of the licensees in making such determination. This demarcation will ensure that the parameters will differ based on the nature of licences and company sizes, this will ensure efficiency and fairness in determining compliance.

The third premise is that the Commission can determine the borrowing capacity of its licensees and ensure that the debt-to-equity ratio is sustainable and the licensees remain financially healthy through proper leveraging. This leveraging will protect licensees and guide the sector to avoid any systematic debt crisis that may impact on other licensees that may have leveraged their ratios adequately. Therefore this determination will be key as the market keeps maturing and its revenue sources are stretched by competition and market saturations.

5.0 The Determination of Capital Structure of Licensees in the Communications Sector

The Commission, in determining the capital structures of its licensees, will consider several elements which will provide the guidance for setting the parameters and benchmarks. It will also facilitate the building of a sector-specific approach to determination of capital structures of its licensees. Accordingly, the following elements will be considered.

5.1 Components of Shareholders' Fund

The Commission in determining the capital structure of its licensees will look at the following components of a licensees' shareholders' fund:

(i) Paid up share capital
(ii) Capital reserve

(iii) General reserve
(iv) Revaluation reserve (tangible assets)
(v) Retained earnings

5.2 Existing capital reserve and General reserve

The Commission will review reserve as a credit balance and refer to a part of shareholders' equity, a liability for estimated claims, or contra-asset for uncollectible accounts. A reserve can appear in any part of shareholders' equity except for contributed or basic share capital. There are different types of reserves used in financial accounting like capital reserves, revenue reserves, statutory reserves, realized reserves, unrealized reserves.

The Commission's focus will be on equity reserves created from several possible sources:

(a) Reserves created from shareholders' contributions, the most common examples of which are:

- *Legal reserve fund* - it is required in many regulatory instruments issued by the Central Bank of Nigeria (CBN) and the Securities and Exchange Commission (SEC). This reserve is required to be paid as a percentage of share capital. This is referred to as paid up share capital under the Companies and Allied Matters Act 2020 in Section 383.

- *Share premium* - amount paid by shareholders for shares in excess of their nominal value.

- *Reserves* created from profit, especially retained earnings, i.e. accumulated accounting profits, or in the case of nonprofits, operating surpluses. However, profits may be distributed also to other types of reserves, for example:

(b) The general reserves created to be utilized for meeting any unknown liability. Strengthening the liquid resources of a licensee. The Commission will review general reserve, which is created by appropriation of profits. It is created without any specific or particular purpose. The aim of creating a general reserve is to provide additional working capital or to strengthen the cash resources of the business, out of profits of the company, from Profit and Loss Appropriation Account.

(c) Any available additional working capital for the licensee from other sources.

(d) Equalizing the rate of dividend in the years in which profits are inadequate. However it will be used for the purpose only when separate dividend equalization reserve is not created.

(e) Concealing actual profits in the years in which profits are excessive to use them to maintain dividend rate in those years in which profits are inadequate.

5.3 Revaluation reserve

The Commission will consider revaluation reserve as a non-cash reserve created to reflect the true value of the asset when the market value of the certain category of asset is more or less than the value of such asset at which it is recorded in the books of account. Any increase in value will be credited (increase the reserve a/c) to this account and any decrease in value will be debited (decrease the reserve a/c) to the account.

This reserve's purpose is to reflect and account for in the books, the real and fair value of an asset. It is expressly excluded from free reserves, and hence this reserve is not available for distribution of dividends to shareholders.

5.4 Retained earnings

The Commission will consider retained earnings as a representation of a useful link between the income statement and the balance sheet, as they are recorded under shareholders' equity, which connects the two statements. The purpose of retaining these earnings can be varied and includes buying new equipment and machines, spending on research and development, or other activities that could potentially generate growth for the company. This reinvestment into the company aims to achieve even more earnings in the future.

If a licensee does not believe it can earn a sufficient return on investment from those retained earnings (i.e., earn more than its cost of capital), then it will often distribute those earnings to shareholders as dividends or share buybacks.

5.5 Valuation of Shareholders investments

The main tool for determination of capital structure is the valuation of shareholders' funds yields, which is an approximation of theoretically how much the shareholders would receive if a licensee were to liquidate. The amount of shareholders' funds can be calculated by subtracting the total amount of liabilities on a company's balance sheet from the total amount of assets. Likewise, shareholder equity also referred to as shareholders' equity is the licensee's owners' residual claim on assets after debts have been paid. Equity is equal to a firm's total assets minus its total liabilities. Shareholder equity can be either negative or positive. If positive, the company has enough assets to cover its liabilities. If negative, the company's liabilities exceed its assets; if prolonged, this is considered balance sheet insolvency.

For this reason, many investors view companies with negative shareholder equity as risky or unsafe investments. Shareholder equity alone is not a definitive indicator of a company's financial health; used in conjunction with other tools and metrics, the investor can accurately analyze the health of a licensee. All the information needed to compute a company's shareholder equity is available on its balance sheet. Total assets include current and non-current assets. Current assets are assets that can be converted to cash within a year (e.g., cash, accounts receivable, inventory, et al.). Long-term assets are assets that cannot be converted to cash or consumed within a year (e.g. investments; property, plant, and equipment; and intangibles, such as patents).

Total liabilities consist of current and long-term liabilities. Current liabilities are debts typically due for repayment within one year (e.g. accounts payable and taxes payable). Long-term liabilities are obligations that are due for repayment in periods longer than one year (e.g., bonds payable, leases, and pension obligations). Upon calculating the total assets and liabilities, shareholder equity can be determined.

Shareholder equity is an important metric in determining the return being generated versus the total amount invested by equity investors. For example, ratios like return on equity (ROE), which is the result of a company's net income divided by shareholder equity, is used to measure how well a company's management is using its equity from investors to generate profit.

5.6 Benchmarks for Debt-to-Equity ratio

The debt-to-equity ratio is a financial ratio indicating the relative proportion of entity's equity and debt used to finance an entity's assets. This ratio is also known as financial leverage. Debt-to-equity ratio is the key financial ratio and is used as a standard for judging a company's financial standing. It is also a measure of a company's ability to repay its obligations. When examining the health of a company, it is critical to pay attention to the debt/equity ratio. If the ratio is increasing, the company is being financed by creditors rather than from its own financial sources which may be a dangerous trend. Lenders and investors usually prefer low debt-to-equity ratios because their interests are better protected in the event of a business decline. Thus, companies with high debt-to-equity ratios may not be able to attract additional lending capital.

Optimal debt-to-equity ratio is considered to be about 1, i.e. liabilities = equity, but the ratio is very industry specific because it depends on the proportion of current and non-current assets. The more non-current the assets (as in the capital-intensive sectors), the more equity is required to finance these long-term investments. In general, a high debt-to-equity ratio indicates that a company may not be able to generate enough cash to satisfy its debt obligations. However, a low debt-to-equity ratio may also indicate that a company is not taking advantage of the increased profits that financial leverage may bring.

Debt to equity ratio is a capital structure ratio which evaluates the long-term financial stability of business using balance sheet data. It is expressed in term of long-term debt and equity. Investors, creditors, management, government etc view this ratio from their different angles influenced by their objectives. Therefore, the meaning and interpretation of this financial ratio vary with the objective with which it is looked at. Debt equity ratio, a renowned ratio in the financial markets, is defined as a ratio of debts to equity. It is often calculated to have an idea about the long-term financial solvency of a business. A business is said to be financially solvent till it can honor its obligations viz. interest payments, daily expenses, salaries, taxes, loan installments etc.

5.7 Borrowing capacity of licensees

The current regulatory prescriptions of the communications sector as it relates to borrowing by licensees is hinged on general licensing conditions that are reactive in most instances. First, it is a key licensing condition that where a licensee is changing its shareholding structure up to 10%, it is required to obtain

prior written approval of the Commission. This in many ways regulate any injection of equity, whether as an investment or debt related placement. Secondly, it is a general licensing condition that a licensee cannot assign or pledge its licence without a prior written approval of the Commission. This is to forestall the arbitrary use of the licence as a collateral or security for untenable loan facilities. The third licensing conditions states that the inability of a licensee to pay up its debts is a ground for suspension or revocation of the licence.

The determination of capital structure will create a requirement to approve borrowing by licensees, this is to ensure a pre-set parameter is not breached and a financial standard maintained. Therefore, a determination of capital structure will create a regulatory need to have an oversight over indebtedness in the sector, through prior approvals and continuous monitoring.

5.8 Acceptable Computation of capital Base

This can be arranged in a sequence that facilitates a review of a licensees' current capital structure as well as determination of any parameters set for the capital structure. The Commission will look at the following in the computation:

5.8.1 Assets Mix Ratio

The assets mix ratio will be based on a minimum capital base as will be prescribed by the Commission for different licensing categories. The liquid assets are cash, bank deposits, treasury bills, collective investment schemes, bonds, quoted/unquoted securities and related investments. The Commission will set the ratio based on the different parameters that may be set based on licensing categories. This will also take into cognizance licensees that are already listed on the Nigerian Stock Exchange.

Furthermore in this determination, the Commission will use different methodologies to determine the asset mix of a licensee. This will be an approach for analyzing investments and determining appropriate allocations based on risk preferences and risk management objectives. Asset allocation portfolios are a blend of both equity and fixed income asset classes. The historical risk and return of these two asset classes will guide the Commission to achieve a balance of risk and potential return

using both equity and fixed-income investments benchmarks. This will be a guiding principle in determining the asset mix of a licensee.

5.8.2 Capital Injection by Shareholders

The Commission will set the rules for determination and confirmation of capital injection by shareholders of a licensee, this is to ensure fair assessment and transparency in the investment. This will also set the foundation for determination of the actual equity and allot it properly to the shareholders.

A shareholder injection occurs any time a company's existing shareholders put cash into the business. In return for this cash they receive either additional shares or if the injection takes the form of a shareholder loan, a promissory note. A shareholder redemption occurs when the company takes cash out of its accounts to buy back shares or repay a shareholder loan. When shareholders receive additional shares for their injection, the company's total shareholder equity account increases and the debt-to-equity ratio improves because the company has increased its amount of equity while its debts remain the same.

When shareholders provide a shareholder loan and receive a promissory note, the company's total liabilities increase and its debt-to-equity ratio worsens. This can be avoided if the shareholder signs a subrogation agreement that that technically reclassifies the debt as patient capital. When this is done, the injection is looked upon as equity. The Commission will review this in line with any parameters it may set.

5.8.3 Transfer of landed assets

The Commission will set the standards for transfer of landed property as an investment by a shareholders in a licensee, whether individual or corporate. This will provide guidance on valuation of the property, location of the property, nature of instrument supporting ownership and consent of relevant authorities.

5.8.4 Transfer of Quoted securities

The Commission will set the standards for transfer of quoted securities as an investment by a shareholder, whether individual or corporate, in a licensee. This will provide guidance on valuation of the securities, location of the stock market, nature of instrument supporting ownership and consent of relevant authorities.

5.8.5 Transfer of other tangible assets (Non-current assets)

The Commission will set the standards for transfer of other tangible (non-current assets) as an investment by a shareholder, whether individual or corporate, in a licensee. This will provide guidance on valuation of the assets, location of the assets, nature of instrument supporting ownership and consent of relevant authorities.

6.0 Mechanism for Determination and Compliance

The Commission will rely on the following mechanisms to determine the capital structure of its licensees and also monitor compliance.

6.1 Review of Financial Statements and Audited Accounts

The Commission understands that capital structure is a mixture of debt and equity that is utilized by a company's operations and there is a close relationship between that mixture and the actual performance of its licensees. This identified relationship between capital structure and corporate performance will facilitate the review of a determined and optimal model capital structure. The review of financial statements and audited accounts of licensees will facilitate the determination of an ideal capital structure and subsequently serve as a fulcrum for confirmation of compliance with the set parameters for each category of licensees.

6.2 Mechanisms for Evaluating Benchmarks and Compliance

The Commission will set compliance benchmarks for different category of licensees with clearly defined parameters. This will ensure that impacted licensees have adequate information that will guide their development of compliance processes to meet the requirements of any regulatory prescriptions that might be issued by the Commission.

6.3 Implementation Approaches and Reporting Requirements

The Commission will develop an implementation approach that will rely on the 'bucket list' strategy, this will ensure that licensees are aggregated into separate lists based on types of licences, company size and current performance. Hence the implementation will be piloted, staggered and finally adopted across board. This approach will ensure that the impact of the possible regulatory requirement will be managed and licensees will have adequate timelines to build compliance capacity.

The reporting requirements and any changes to existing processes will also tow the same line and such requirements will be phased and properly aggregated to ensure fairness in implementation of any regulatory instrument in that regard. Reporting requirements will be set out with timelines and guidance notes that will outline what will constitute adequate compliance and remedial procedures where necessary.

6.4 Regulatory Implementation Timelines

The Commission will set Regulatory Implementation Timelines based on the steps below:

Step 1

Commencement of Consultation process and Stakeholders engagement

Step 2

Development of a Draft Framework/Guidelines

Step 3

Issuance of a regulatory instrument

Step 4

Commencement of a Pilot Implementation Process

Step 5

Commencement of a staggered and structured implementation process

Step 6

Compliance review and implementation audit

7.0 Conclusion

This consultation process is an important part of the Commission's rule-making mandate and it is key in creating regulatory frameworks. Thus, the Commission is conscious of the importance and necessity of the process and expects feedbacks and inputs from all stakeholders. The process will enrich the regulatory outputs of the Commission and will further strengthen the market in Nigeria. Therefore, this process will serve as a fodder that will facilitate the Commission's desire to strengthen, protect and sustain the communications sector.