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ANALYSIS OF THE CAPITAL STRUCTURE DECISIONS: A SURVEY OF THE SERBIAN COMPANIES

Analiza odluka o strukturi kapitala na primeru kompanija u Srbiji

Abstract

Our research intends to identify the pecking order theory implementation and both the internal and external factors influencing the companies' debt policy on a sample of 65 companies in Serbia during 2015. The answers were provided by 65 CFOs. The results obtained from the survey indicate that most respondents are inclined to use internal funds, as opposed to external funds. Further analysis of external sources used by the firms in the sample suggests that firms are mostly inclined to use bank loans (59%), leasing (26%), debt securities (8%) and finally equity securities (4%). The results show that the most dominant internal factors influencing the debt policy of the companies in the sample are credit rating of the company and financial slack. And finally, the results indicate that the restrictive and costly credit policy of the banks in Serbia influence the companies' access to external financial means.

Keywords: *pecking order theory, financial decision, internal financing, external financing, restrictive credit policy*

Sažetak

Cilj istraživanja je ispitivanje mogućnosti implementacije teorijskog koncepta 'pecking order theory' kao i analiza internih i eksternih faktora koji utiču na politiku zaduživanja na primeru 65 kompanija u Srbiji tokom 2015. godine. Odgovore na pitanja je dalo 65 finansijskih direktora. Odgovori ukazuju na činjenicu da većina kompanija preferira interne izvore finansiranja u odnosu na eksterne. Ako se dalje analiziraju eksterni izvori, kompanije u Srbiji najčešće koriste bankarske pozajmice (59%), usluge lizinga (26%), dužničke hartije od vrednosti (8%) i na kraju obične akcije (4%). Rezultati su pokazali da najdominantniji interni faktori koji utiču na politiku zaduživanja kompanija jesu kreditni rejting kompanija, kao i višak novca, odnosno gotovine. Takođe, rezultati ukazuju da restriktivna i skupa kreditna politika banaka najviše utiče na pristup kompanija eksternim sredstvima.

Ključne reči: *pecking order teorija, finansijske odluke, interno finansiranje, eksterno finansiranje, restriktivna kreditna politika*

Introduction

In this paper, we shall examine current practices in the capital structure decision-making process on a sample of 65 companies in Serbia. We relied on the pecking order theory to formulate our initial hypotheses. Since bank financing is the primary source of capital in Serbia, our analysis particularly focuses on determinants influencing debt policy of the companies and the obstacles they encounter when obtaining this kind of external capital.

Investments play an important role and are the key factor of economic growth of every country. Within the context of economic turmoil, most countries try to promote a smart, sustainable and inclusive economic growth. Yet, growth cannot be achieved without long-term capital projects involving a large amount of financial resources, which usually cannot be provided from the internal companies' resources. Consequently, a stable financial system with efficient financial markets is a necessary precondition for successful implementation of the companies' investment policies. The financial feasibility of a project has to be determined prior to an actual investment, emphasizing once more the necessity for creating a stable financial environment within which the companies will be able to obtain the capital necessary for both everyday business activities and their investment policy implementation.

In order to gauge the general trend regarding capital structure decisions made by firms in Serbia and to assess its advantages and disadvantages, we will compare our results with those obtained in similar surveys conducted in the United States of America (USA), Canada, Western Europe (WE) and Central and Eastern Europe (CEE). We will try to identify certain similarities and finally, we will try to determine whether factors such as ownership, size of the enterprise and industry influence the choice of capital structure and the frequency and type of obstacles while obtaining external funds.

Consequently, the following hypotheses will be tested:

H0: Companies in Serbia use external financing only when internal resources are insufficient.

H1: Companies in Serbia are inclined primarily to use debt when internal funding is not sufficient. They use equity only when other sources of external financing are not available.

H2: Financial slack and credit rating of the enterprises are the most dominant internal factors influencing the debt policy of the companies in Serbia.

H3: High level of interest rates, a restrictive credit policy imposed by the banks and lack of external funding are the most dominant external-financing obstacles encountered by the companies in Serbia, especially with respect to bank loans.

This paper is structured as follows. Within the first section we present a literature review, along with relevant findings of similar surveys in different countries and regions. Within section two, the methodology is presented, including a detailed description of our questionnaire. The third section introduces the results of our survey and simultaneously compares them with prior research conducted in the USA, Canada, WE and CEE. Finally, we present the conclusions.

Literature review

This paper addresses two major research questions: the implementation of the pecking order theory on the companies in the sample and the most frequent obstacles that companies in Serbia encounter when obtaining external funds (both internal and external obstacles). The pecking order theory implies that the companies prefer internal financing, followed by debt and finally equity. There was a number of surveys that examined these questions. For instance, Graham et al. used a sample consisting of 4,440 companies and 392 CFOs (Chief Financial Officers) that participated in a survey conducted in the USA and Canada [7, p. 188]. The main themes were cost of capital, capital budgeting and capital structure of the companies. The results of the survey implied that: (a) most firms in the sample had a tight target debt ratio and the CFOs relied heavily on practical, informal rules when choosing the capital structure; (b) the most dominant factors influencing the firm's debt policy were financial flexibility and a good credit rating of the company; (c) the respondents were mostly concerned with earnings per share, dilution of ownership and possible recent stock price appreciation; (d) the executives did not worry too much about asset substitution, asymmetric information, transaction costs, free cash flows or personal taxes when determining the debt policy of the company.

The practical implementation of the pecking order theory was in the focus of various authors, explaining the possibility of implementation of contemporary finance theories in everyday business activities. For instance, Pinegar used the survey consisting of a list of the Fortune 500 firms for 1986. His main conclusion was that CFOs in the sample were more inclined to follow the financing hierarchy than to maintain a target debt-equity ratio. The results showed that companies preferred financial slack, followed by debt and finally equity [11, p. 89].

Using a sample of firms listed in the French Stock Exchange market within the period from 1999 to 2005, Atiyet showed that the capital structure of the companies in the sample relied on the pecking order theory as well [2, p. 9]. The results obtained implied that: (a) internal fund deficit was the most important determinant influencing the decision regarding the issuance of a new debt; (b) the benefits regarding tax shield had a small effect on debt issuing decisions. Generally, the French firms in the sample were more inclined to use internal rather than external financial resources, and these results were mostly explained by the presence of asymmetric information.

Further, while analyzing companies in Europe, Kamoto examined the correlation between the managers' characteristics and their financial decisions. His survey: (a) revealed that optimistic and overconfident managers financed their investments with internal funds to avoid the additional costs of undervaluation imposed by equity financing (resulting from asymmetric information when the company is issuing equity); and (b) showed that managers would rely on internal resources and debt rather than on equity, thus again confirming the pecking order theory [9, p. 123].

Using the IFC database covering 10 developing countries (India, Pakistan, Thailand, Malaysia, Turkey, Zimbabwe, Mexico, Brazil, Jordan and Korea), Booth et al. concluded that: (a) the profitability of the company influenced the level of its debt, indicating that the more profitable a company, the lower its debt ratio; (b) the determinants influencing financial decisions were the same in both developed and developing countries; and (c) the role of the institutional framework was one of the most dominant factors influencing the choice of capital structure [5, p. 128].

Within the survey that covered executives of companies in ten countries in CEE – Bulgaria, Croatia, the Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia, Andor et al. found that the most preferred source of funds was retained earnings (internal source of funds), followed by straight debt, i.e. companies' preferences suggested by the pecking order theory [1, p. 43].

Haas et al. examined in their paper the relationship between the banking system development and the companies' capital structure targets in Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The results obtained revealed that the development of the financial systems within this region enabled companies to reach higher levels of debt and to bring their actual capital structure closer to their own target structures [8, p. 166].

After analyzing the literature related to the expected hierarchy of financial resources used by the companies and to the main determinants influencing their debt policies, we move to the second part of our literature review that tackles issues regarding the most common obstacles that companies encounter when they use external sources of capital.

For instance, Gonenc conducted a survey using the Thomson Financial Worldscope database within the period from 1991 to 2006. The results showed that the more developed the financial system was, the fewer obstacles the companies encountered when obtaining external capital [6, p. 186]. Osman concluded that the companies operating in countries with a higher asset share of foreign-owned banks reported a higher access to external financing [10, p. 33]. In addition to this, many surveys indicated that the size of the firm played an important role regarding the level (and the type) of the obstacles encountered. Osman, for example, emphasized that large firms in comparison to small and medium-size firms had better access to financing and lower costs of financing [10, p. 34]. The survey was conducted in 28 CEE countries, including Turkey.

Toci also emphasized the correlation between the size of the firm and the financing obstacles [12, p. 58]. The survey was conducted in transition economies in 1999, 2002 and 2005, and it covered approximately 4,000–9,000 firms. The main conclusion was that small firms were relatively more constrained compared to large companies. (a) Small firms relied more on internal resources in comparison to external ones, and were more likely to be refused when applying for a loan, thus facing greater difficulties in accessing both short- and long-term loans. (b) High interest rates and high collateral requirements posed a greater obstacle to everyday business of small firms in comparison to larger ones. (c) The decrease of financing constraints (over time) was greater for small firms than for larger ones, indicating changes in the credit policy of financial institutions towards the small business sector.

In their survey, Beck et al. used a database for 74 countries, involving large, small and medium firms (10,000 companies). The aim of their survey was to determine effects of the banking market structure on the companies' financing. The results were: (a) a larger share of foreign-owned banks and an efficient credit registry reduced obstacles imposed on companies using external funds, while restrictions on banks' activities, government interference and a greater proportion of state-owned banks increased the effect of financing obstacles. (b) The smallest firms were more affected by all obstacles relative to larger firms. (c) The most dominant obstacles were bank paperwork and bureaucratic matters, inferring that the red tape should be addressed as one of the largest obstacles influencing the companies' everyday activities. (d) High collaterals and excessive documentation needed for leasing activities appeared to be constraining the companies' daily business. (e) Setting up a healthy business environment, along with an efficient regulatory system, needs to be among the top priorities in the developing countries [3, p. 645].

Methodology

Relying on contemporary finance literature, the authors created a questionnaire divided into four sections: questions related to capital-budgeting techniques and cost of capital, questions regarding capital structure issues and the pecking order theory, questions that concern dividend policy and final fourth part refers to enterprise risk management concept ("ERM concept"). This paper focuses on two of the abovementioned areas, more specifically on the second section of the questionnaire: capital structure and the pecking order theory. Additionally, there was an introductory part as well, containing questions regarding industry, ownership, etc. We modeled our questionnaire on the one used in a survey conducted by Graham and Harvey in 2001. This survey was based on a large sample and a broad cross section of firms. The sample consisted of 4,440 firms and 392 CFOs that participated in the survey, with a response rate of 9%. The final version of their survey contained 15 questions and was three pages long.

It is important to emphasize that our paper presents only the results relating to the second part of the questionnaire. Although our questionnaire includes 45 questions, the second section that relates to capital structure and the pecking order theory issues has only 10 questions. The respondents were asked to score the frequency of each factor influencing their capital structure decisions by using a scale of 1 to 5 (1 meaning "never", 5 meaning "always"). Additionally, the respondents were asked whether they used internal or external funds in their everyday business decisions and in their investment financing. They were also required to answer if they encountered financial obstacles when they decided to use external funding. Further, they were instructed to rate the hierarchy of the choice regarding external ways of financing (for instance, debt financing, equity financing, leasing etc.). Moreover, the respondents were asked to rate the frequency of the presence of the obstacles using a scale from 1 to 5 (1 meaning "never", 5 meaning "always"). The draft of the questionnaire was sent to financial analysts and experts for a review before sending it to the respondents, and it was approved by them. The questionnaires were then sent to CFOs by mail. In addition, we offered an option to call the respondents by phone in the event of ambiguities to diminish the possibility of incorrect or biased answers.

Our sample consists of 65 companies (out of 392 that received our enquiry during 2015). The aim was to cover most of the industries in the country and to include as many companies as possible, varying in their size and ownership patterns. Within the sample, the companies range from micro to large companies (micro 34%, small 20%, medium 20% and large 26% of the sample).[1] Furthermore, the analysis of the ownership shows that 40% of the companies in the sample are foreign-owned firms and 60% are domestic ones. Finally, 25% of firms in our sample are manufacturers. The non-manufacturing firms are equally distributed across other industries: financial (20%), retail and wholesale (20%), hospitality (15%), telecommunications (5%), IT sector (5%) and consulting companies (10%). We analyzed responses according to the companies' characteristics (size, ownership, industry).

Finally, the answers were processed in the SPSS statistical program.

Results

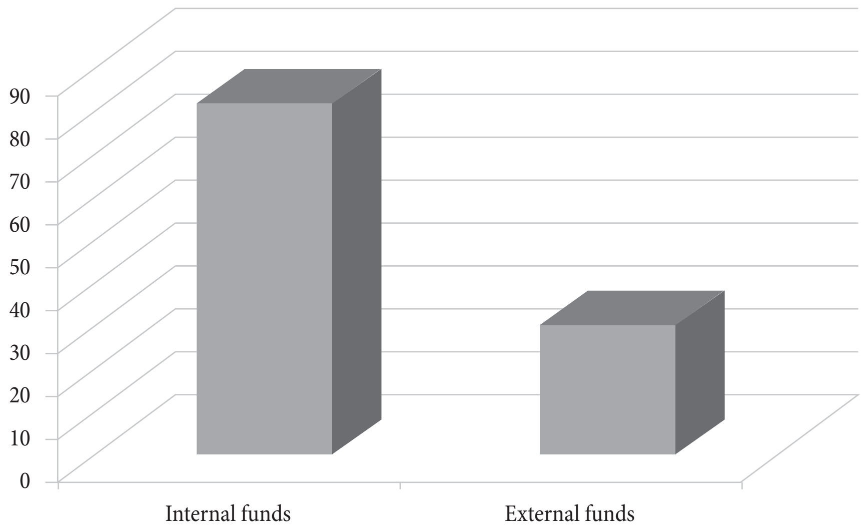
This section is structured as follows. Within the first part we test our H0. Further, within the second part, the H1 is tested. In the third part of this section H2 is tested. And finally, within the last part, H3 is tested.

1 According to the Law on Accounting and Auditing, enterprises are classified in the following categories:
Micro: (annual average number of employees (AANE) ≤10; annual sales (AS) ≤ RSD 84,671,000 and annual average asset value (AAAV) ≤ RSD 42,335,000);
Small: (10 ≤ AANE ≤ RSD 50;84,671,000 ≤ AS ≤ RSD 1,064,433,000; RSD 42,335,000 ≤ AAAV ≤ RSD 532,217, 000);
Medium: (50 ≤ AANE ≤ RSD 250; 1,064,433,000 ≤ AS ≤ RSD 4,233,541,000; RSD 532,217, 000 ≤ AAAV ≤ RSD 2,116,770,000);
Large: (AANE ≥ 250; AS ≥ RSD 4,233,541,000 and AAAV ≥ RSD 2,116,770,000).

The results referring to the choice of financial resources by the companies in the sample are summarized in Figure 1.

As presented, most respondents prefer to use internal relative to external funds. In the questionnaire, we asked the CFOs how often they used both internal and external funds. It is important to stress out that there were two separate questions regarding the frequency of usage of internal and external funding. The results show that 82% of the respondents are more inclined to maintain the financial slack, i.e. the available extra money that a company can use in the case of downturn in everyday business activities. Simultaneously, the results show that 30% of the respondents always and very often use external funding. In respect of the companies' size, the results indicate that small and micro firms are more willing to use their own resources in comparison to external capital. Further, firms within the retail and wholesale sectors, IT companies and companies in the hospitality industry are the most inclined to use internal funds in comparison to external and, also, relative to other sectors in the sample. Our findings confirm that the size of the company influences the capital structure, indicating that small firms are more willing to avoid additional costs imposed by external financing and that they are more likely to be rejected when applying for a loan as opposed to large companies. This is in line with the current restrictive banks' credit policy in Serbia, where the banks are not willing to invest in business proposals

Figure 1: Percentage of respondents (CFOs) who always or often use the given financial resources



Source: Results of the survey conducted by the authors

put forward by small, unfamiliar companies with no track record. Banks are more prepared to extend a loan to large companies that can provide better collaterals and that are too large to fail (indicating the presence of moral hazard). Regarding the ownership, both foreign and domestic companies prefer internal funds to external financing. Key reasons for unwillingness to use external funds provided by the respondents are unfavorable financing conditions offered by the Serbian banks, inefficient capital markets and an inadequate supply of financial products offered by financial institutions in Serbia.

The results coincide with those obtained in surveys conducted by Harvey and Graham in 2001 and Pinegar et al. in 1989 regarding the absence of a specific debt/equity ratio targeted by firms. They also imply the existence of a hierarchy among the Serbian firms implied by the pecking order model of financing. Consequently, when the results from these surveys are compared, it is evident that the general situation regarding the preference of the companies towards internal financing in comparison to external has not changed over this long period of time.

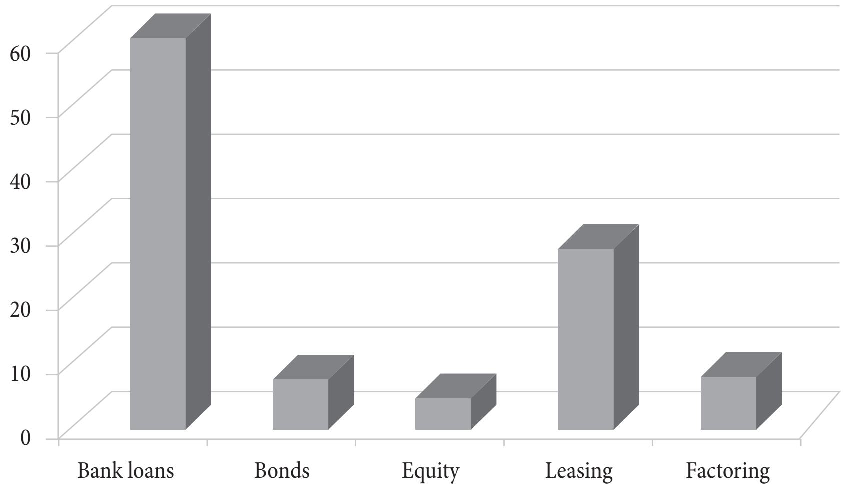
Furthermore, our results are in correlation with findings of Beck et al. [3] and Osman [10], stating that small and medium firms are more inclined to use internal resources in comparison to larger companies.

The presented results from our survey confirm H0 of the paper suggesting that the companies in Serbia use external financing only when internal resources are insufficient.

The results referring to the choice of external financial resources by the companies within the sample are summarized in Figure 2.

These results show that the analyzed firms are primarily inclined to use bank loans (59%). The second most dominant source of the external financing is leasing (26% of companies in our sample use this type of external funding), then issuing debt securities (8%) and finally issuing equity securities (4%). The Serbian financial system is bank-oriented because the Serbian capital market is inefficient and shallow. Consequently, the companies are more willing to take out bank loans in comparison to issuing, for instance, corporate bonds or equity securities. However, the scarce usage of the financial instruments other than bank loans may additionally be the result of general distrust towards new financial instruments and the lack of knowledge. The same trend is observed regardless of the company's size. All types of companies prefer bank loans, followed by leasing, corporate bonds and, finally, equity. Further, the firms in pharmaceutical, agricultural, retail and wholesale sectors provided the highest response rate regarding the frequency of using bank loans (90%, 99% and 70% respectively). Finally, both foreign and domestic companies predominantly use bank loans. This finding indicates that even companies that are an integral part of multinational businesses find the Serbian market of external financing inefficient, with an inadequate offer of financial instruments. This in turn forces even them to be primarily focused on bank loans as opposed to

Figure 2: Percentage of respondents (CFOs) who always or often use a certain kind of external financial resources



Source: Results of the survey conducted by the authors

other types of external financing. Furthermore, they are more willing to use credit lines provided by their parent company, since these bear more favorable conditions in comparison to the loans offered by the Serbian banks.

Our results coincide with those acquired in surveys conducted by Graham et al. [7], Atiyet [2] and Haas et al. [8].

With the presented results and after the analysis, we have confirmed our H1, implying that companies in Serbia are inclined to use debt when internal funding is not sufficient and that they use equity only when other sources of external financing are not available (i.e. are exhausted).

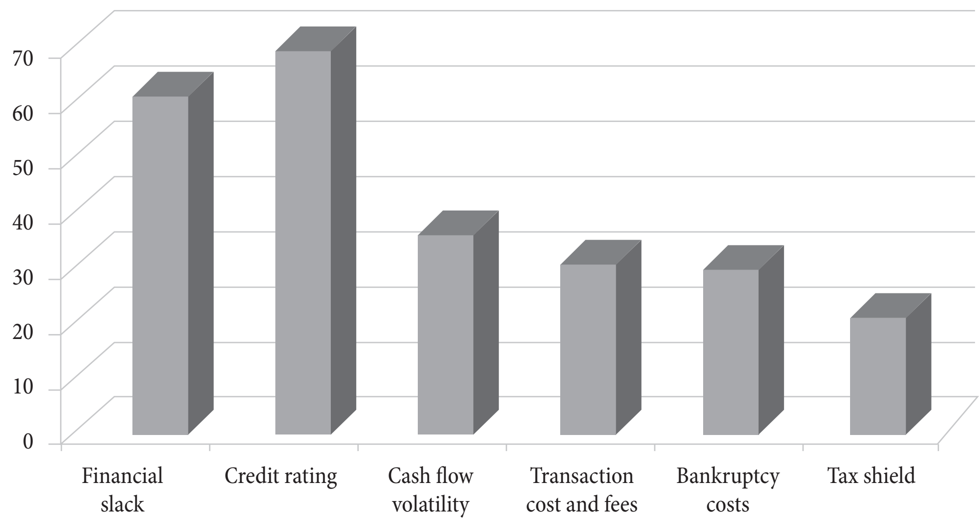
As it is clearly exhibited in Figure 3, the most dominant internal factors influencing the debt policy of the companies in the sample are the credit rating of the company and financial slack. Within the economic turmoil, the company's sensitivity to the cost of capital appeared to be the most important component influencing its final financial decisions. Credit rating, mostly gained from banks, appears to be the dominant factor influencing the debt policy of the firms. Consequently, the lower credit rating unavoidably leads to higher interest rates, i.e. higher cost of capital, given the fact that banks want a higher return due to the lower credit rating of the borrower. Finally, the term 'financial slack' refers to the habit of the companies to restrict debt in order to have internal resources available for new business opportunities (61% of the CFOs indicated that this is the most frequent factor influencing the debt policy of their respective firm). The latter coincides with the previous conclusion that companies prefer internal funds to external, and this preference deeply influences the company's debt policy. The same trend is observed regardless of the company's size. All types of the analyzed companies marked these factors as the main determinants influencing their debt policy. However, costs of financial distress turned out to be the key factor influencing debt policy of micro firms. These results correlate with those obtained in the survey conducted by Beck et al. [4]. Further, the companies in agricultural, trade and hospitality industry marked both the financial slack and their credit rating as the most dominant factors influencing their debt policy. Finally, both foreign and domestic companies perceive the latter as the most dominant internal factors, indicating the general trend of the companies in Serbia.

The presented analysis confirmed H2 of the paper – specifically, financial slack and credit rating are the most dominant internal factors influencing the debt policy of the companies in Serbia.

The respondents were required to answer whether the firms encountered the obstacles when trying to obtain external financing. The results are presented in Figure 4.

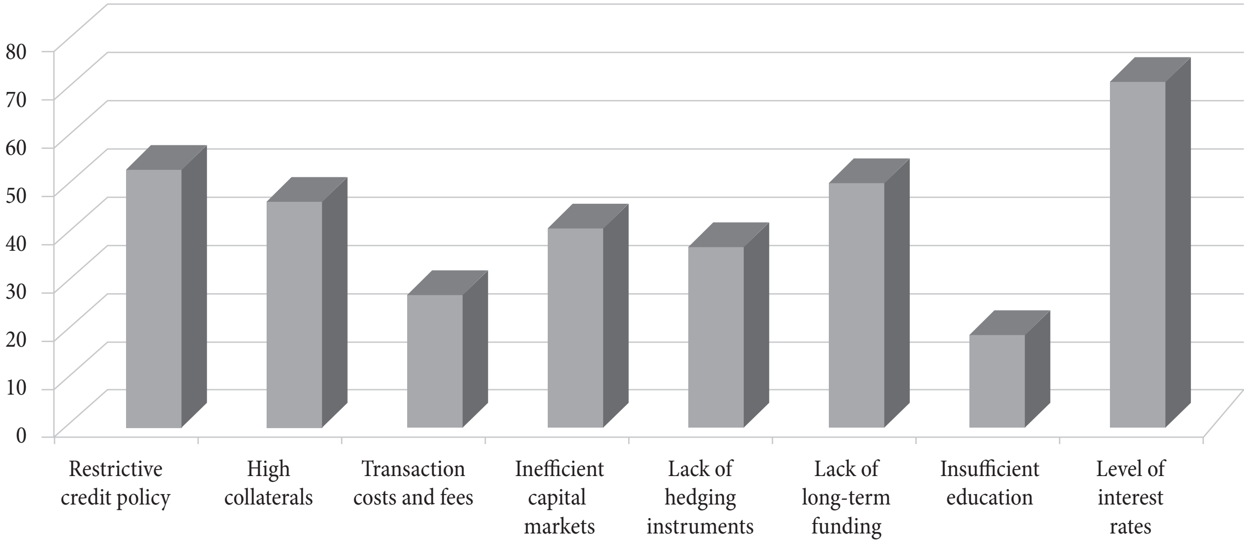
The results show that the firms most frequently encounter the following obstacles when obtaining the external funds: level of interest rates (70%), restrictive credit policies (53%), lack of long-term funding (50%) and high collateral requirements (47%). The restrictive banking

Figure 3: Analysis of debt policy factors



Source: Results of the survey conducted by the authors

Figure 4: Percentage of respondents (CFOs) who always or often encountered the following obstacles when acquiring external funds



Source: Results of the survey conducted by the authors

policy and the red tape may produce obstacles for the firm in its everyday business. The restrictive banking policy involves per se high collaterals as a way of securing the bank's investments. However, this can be very discouraging for the already exhausted Serbian companies, especially for the small firms that may well be solvent and with profitable projects, and yet with insufficient assets to invest in lucrative ideas or to provide the acceptable collateral. The banking sector's credit policy is very restrictive in respect of increasing the volume of loans. Consequently, this restrictive policy inevitably influences the companies' access to external financial means. The more restrictive banks' credit policy is, the fewer funds are available for already insolvent companies in Serbia. The lack of long-term funding may appear as problem in the future, because it influences capital budgeting policy of each firm and the financing of long-term projects essential for growth at the macro level, especially in the conditions of economic turmoil and general insecurity. The same trend is easily noticeable when analyzing the companies in terms of their size. All types of companies marked these factors as the main determinants influencing their debt policy. However, when it comes to the size of the firms in the sample, small and medium firms indicated these obstacles as the most jeopardizing ones. The latter coincides with the results obtained by Beck et al. [4], i.e. our results simultaneously show that smaller firms are more sensitive to the financial obstacles than the larger ones. Finally, both foreign and domestic companies emphasize these issues to be the greatest obstacles when acquiring external capital, indicating that business environment improvement should be one of the top priorities in the following period.

Thus, H3 of the paper has been confirmed, stating that high level of interest rates, a restrictive credit policy imposed by the banks and the lack of external funding are the most dominant external financing obstacles encountered by the companies in Serbia, especially with respect to bank loans.

Conclusion

Our research aimed at identifying the pecking order theory implementation and both the internal and external factors influencing the companies' debt policy on a sample of 65 companies in Serbia. The authors confirmed four hypotheses.

- H0 states that companies in Serbia use external financing only when internal resources are insufficient.
- H1 states that companies in Serbia are inclined to use debt when internal funding is not sufficient and that they use equity only when other sources of external financing are not available.
- H2 emphasizes that the company's financial slack and credit rating are the most dominant internal factors influencing the debt policy of the companies in Serbia.

- H3 refers to a restrictive credit policy of Serbian banks, a lack of adequate external funding and high interest rates as the most dominant external financing obstacles encountered by companies in Serbia, especially with respect to bank loans.

The general conclusion is that the Serbian market of external financing is inefficient, with an inadequate offer of financial instruments. The companies, when internal funding is lacking, are mostly inclined to use bank loans. Bearing in mind that the Serbian financial system is bank-oriented, the results are not so surprising. Finally, internal factors such as financial slack and credit rating of the companies influence the debt policy. The better the credit rating is, the more favorable conditions regarding cost of capital are. Restrictive credit policy, high level of interest rates and high collaterals pose the greatest obstacles regarding external financing. However, the already mentioned obstacles mostly refer to bank loans. The latter implies the necessity for creating a favorable business environment for implementing alternative ways of acquiring capital (venture capital markets, business angels etc.). Creating a diversified financial environment with equal opportunities for all types of the companies, especially for small and medium enterprises, may be essential for the development of the country both on macro and micro levels.

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