FACTORS AFFECTING THE DEBT USAGE OF MANUFACTURING COMPANIES CASE OF ALBANIA

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ABSTRACT

During the recent years, there has been a growing interest in identifying the factors influencing debt financing within companies. Based on the materials found in companies part of the manufacturing sector, there are examined main factors that affect the degree of debt utilization within different corporations. Debt financing is mainly focused towards short-term liquidity needs. The manufacturing sector mostly needs debt financing in its starting phase of the business because of the technologies it has to incorporate and the modern equipments it needs to have to carry out the company's mission. Difficulties in finding sources of funding have been presented as a problem that accompanies Albanian companies. Since we already have consolidated businesses, funding sources are not only necessary in starting a business, they are also very important in the growth of an entity as well as in financing long-term projects or investments. It is very important to identify the main factors that affect the debt usage. Debt utilization rate is based on a thorough analysis in order to have more benefits from this way of financing than to pay more for the sources of funds. This paper will address the factors that influence the rate of usage of borrowed funds in Albanian companies which are part of the manufacturing sector. Factors influencing the choice of debt financing remain defined despite the various theoretical literatures. There are a number of general factors that have an impact on all entities regardless of the sector they belong to, then depending on the sector we have the most influential great and decisive ones.

Keywords: Capital structure, debt level, leverage ratio, manufacturing companies.

INTRODUCTION

When we discuss about economic units especially part of the manufacturing sector, we immediately think about the form of financing and simultaneously we think about the degree of debt usage taking into consideration the expensive technologies and equipment needed to realize various products. Companies need sources of fund from the moment of creation and onwards in order to finance their growth, to finance investments in fixed assets, to finance long-term projects. Albanian companies do not suffer from the lack of capital but from the lack of its effective use. In Albania the capital reserves per capita deposited in the Albanian banking system are higher compared to some post – communist countries in the Balkans. The capital deposited in the Albanian banking system is invested in domestic business at a lower level compared to some other Balkan countries. Low lending is one of the factors of Albania's high trade deficit. Effective use of capital would have mitigated this deficit. The various theories about the structure of capital are among the most attractive and complicated issues in the field of finance. The capital structure is one of the main issues which is in the focus of finance mentioning here the impact of the capital structure on the value of the firm and the change of the capital structure itself. The main goal of the managers of a company is to

maximize the value of the firm, thus to maximize the value of the stocks. One of the ways to achieve this is to change the structure of capital by minimizing the costs and maximizing profit through the use of debt as a possible form of financing. Companies finance their assets through two main sources: debt and equity. The debt can be obtained through various forms such as loans and the issuance of bonds while capital can be obtained through the issuance of new shares of the company. Most companies combine these ways of financing, giving more weight to one or to the other form of financing. Knowing a firm's debt ratio or its capital structure can help us understand from a broader perspective how the company operates and whether that company will successfully continue its market activity. Debt is a thorny problem: when it is used properly, it enables the company to have higher levels of profitability for an unchanged level of capital but if it is used in an uncontrolled manner, the company can result in bankruptcy. A company with a high debt ratio has difficulties in expanding debt financing as creditors can only lend at high interest rates (Merollari, 2012). A series of reports are used called leverage ratios in order to measure the degree of debt financing in a company. About 60% of businesses in Albania operate with debt. The question that arises is what drives these businesses to borrow money. This paper will address the factors that influence the rate of usage of borrowed funds in Albanian companies which are part of the manufacturing sector.

LITERATURE REVIEW

The argument for the existence of debt at the optimal level has been one of the main topics of field theorists for many years. The optimal level of debt is one that would minimize the firm's costs and maximize its value. According to the theory of Modigliani and Miller it is believed that the usage of financial leverage will increase the value of the entity. In a later paper, (Modigliani&Miller, 1963) showed that in an imperfect capital market where interest costs are deductible the value of the entity can increase with a high financial leverage. They conclude that the structure of capital is particularly important. The main difference in this assumption is that entities pay a tax on their income and the tax law defines that the interest expense is deducted (Myers, 2001) argued that there is no universally accepted theory for the choice of debt financing. However, he acknowledges the fact that there are some conditional theories that have been accepted. Much of the corporate finance literature shows the "trade theory" in which bankruptcy taxes and costs are considered. According to this theory, corporations seek levels of debt financing that balance the tax advantages of additional debt versus potential bankruptcy costs (Myers, 2001). (Huang&Song, 2006) advocate the theory that paying off debts reduces the cash flow available to managers and executive committee. The companies whose debt level is low have more investment opportunities compared to other similar companies in the industry and therefore they do have more liquidity. (Jain, 2003) has proposed another theory regarding the operating performance of an entity. She argued that if executives had access to private information which might anticipate a worse performance of the company in the future, they would increase the debt level in their firm. However, the increase in leverage is a negative sign and indicates a poor performance in the future.

METHODOLOGY

Methodology is very important and it is used to achieve the objectives of this study. The methodology used for identifying the factors which influence the degree of debt utilization is mainly based on secondary data obtained from different sources as well as it is based on information obtained from the literature review.

1.1 Ratio between internal and external sources

Internal sources of financing make up the bulk of the funds for financing the activity of companies, usually between 50-70%. Although in certain periods of time the external sources of financing increase significantly, they remain of less importance compared to the internal sources of financing.

The ratio between internal and external sources of funding depends on several factors such as:

1. The amount of funds needed
2. Profit rate of operations
3. Opportunity cost of retained earnings
4. Costs associated with external sources of funding
5. Availability of external resources for the company
6. Dividend policy of the company
7. Short-term sources of funding

Short-term sources of financing are used to finance short-term assets and are repaid within one year.

The main sources of short-term financing are:

1. The Commercial Loans

It is a source of occasional funding and it is extremely important especially for small businesses. Short-term loans obtained from commercial banks are presented in the balance sheets of companies as "Loans from commercial banks" and it is the second most important element after commercial loans as a source of short-term financing.

2. The Commercial letters

Securities are used as a source of short-term financing by large companies.

3. Factoring

It is another form of short-term financing. Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable to a third party called a factor at a discount. This form of financing is convenient and advantageous but can be costly. In our country this form of financing is not used because there is a lack of financial institutions to play the role of factor. Few firms can exist without short-term funding. Medium-term sources of financing are repaid within a period of 1-5 years and are used to finance medium-term investments.

The main forms of medium-term financing sources are:

1. Medium term Bank Loan

This loan is given to a business by commercial banks for a period between 1 to 5 years. Repayment is made in installments and the interest expense is calculated on the remaining debt. The building mortgages are used as collateral. It might happen that large companies can borrow this kind of loan at banks without collateral.

2. Conditional Sales Contracts

Conditional sale presupposes the retention of the seller's ownership of the equipment until the buyer makes the full payment. It is used to finance the purchase of new equipment by companies.

3. Leasing contracts

Lease contracts are a modern form of medium-term financing. They take different forms, but the most important are:

a. Sale and temporary leaseback.

The company that owns the equipment initially sells them to a financial institution. At the same time it makes an agreement for renting these equipments previously sold.

b. Operating lease contracts (full service leasing).

The landlord pays the cost of maintenance of the equipments. The tenant may terminate the contract before its expiration date.

c. Financial lease contract.

The landlord does not pay for the cost of maintenance of the equipments. These types of contracts cannot be terminated before their expiration date.

Sources of long-term financing:

Companies use long-term resources to finance long-term projects. Common stock, preferred stock and long-term debt (bonds) are included in the long-term financing sources. Common stocks as a source of financing have a number of advantages and disadvantages for the issuing company.

Advantages:

1. Common stocks have no fixed costs. The company pays dividends only if it makes a profit.
2. The sale of stocks increases the company's ability to borrow.
3. Common stocks are sold easier than debt securities.

Disadvantages:

1. The sale of Common stock increases the voting rights or control of other shareholders entering the company. Therefore, the equity financing is often avoided by companies. Owners or managers may not be inclined to share control of their company with others.
2. Common stocks give a larger number of owners the right to gain profits. On the other hand, using debt can put the company in a position to use low-cost funds while common stocks give new shareholders the right to receive the company's net profits.
3. The costs of subscribing and trading common stocks are usually higher than those for subscribing and trading preferred stock or debt securities.

There are some advantages and disadvantages based on assessment of long-term debt as a source of financing from the point of view of the company issuing these bonds.

Advantages:

1. The cost of the debt (interest of the bonds) is determined in the moment the security is issued and does not change until expiration of their repayment period. Bondholders do not participate in the huge profits the company can make.
2. The percentage of repayment provided for the bonds is lower than that of common or preferred stock
3. Shareholders do not lose any part of control over the company if they use debt financing.

Disadvantages:

1. Bonds have a fixed cost which must be paid even in terms of non-realization of profits. This can lead to non-payment of interest which in turn increases the fear of lenders who may demand the return of whole principal amounts.
2. Bonds usually have a well-defined repayment period. Thus, the financial manager must take precautionary measures for its settlement. One such measure as it is known is the creation of a financial depreciation fund.

1.2 The cost of debt

Debt capital includes all long-term borrowings of the company. The cost of debt is lower than the cost of other forms of financing. This is because lenders bear less risk than long-term equity contributors. Their risk is lower because:

1. Shareholders have a higher priority to have rights over available profits or assets compared with bondholder.
2. Bondholders exert a much greater legal pressure against the company for receiving of payments compared to shareholders. The cost of debt is related to the interest rate, the tax rate over corporate income and the risk. Tax laws allow the deduction of interest before

calculating the taxable income of the company. Interest costs are shared with the state so the effective cost of debt financing is reduced.

1.3 Which combination of debt and equity financing minimizes the cost of company capital?

The best combination of company financial resources is called the optimal capital structure. The optimal capital structure gives the advantage of financial leverage without excessive increase of financial risks. It minimizes the overall cost of the company's funds. The cost of debt is lower than the cost of equity. Debt is cheaper because it is less risky for the investor than the ownership and the state allows interest expense to be deducted before taxable income is determined. Company management can reduce the cost of capital by replacing equity with debt. However, as the weight of debt-financed assets increase, the company becomes more risky and both the cost of debt and the cost of share capital increase. The Management of the Company should determine the optimal combination of the debt financing and equity financing which will minimize the cost of the company's capital. As this combination is determined, the management should seek to maintain this particular combination of debt financing and equity financing. The optimal capital structure is estimated to be compounded by 40% debt financing and the rest is the invested capital of the owners and shareholders.

1.4 Financial leverage and risk

Financial leverage exists when the company uses debt financing, when the company after securing the funds can earn more than it has agreed to pay for the sources of funds. That is, if the company secures the funds at an interest rate of 10% and earns from them 12%, the additional 2% goes to the owners of the company which in turn increases the company's profits. Although the financial leverage increases owners' profit rate, debt financing is not used in high ratios as it increases the financial risk and in turn the company becomes more risky. This increase in risk increases the possibility of fluctuations of shareholders' profits. The capital structure of a company must be built keeping in mind the risk. The capital structure is associated with a level of financial risk. The more debt financing is part of the capital structure, the greater is the financial leverage and financial risk. The weight that debt occupies in the capital structure of the company is very important. The use of debt increases the risk because the debt is associated with a fixed cost in the form of interest expense and return on principal. Failure to pay interest ultimately leads to bankruptcy. A company whose capital structure is highly depended on debt has difficulty expanding debt financing as creditors can only lend at high interest rates. On the other hand, the debt also represents potential opportunities for greater profits for the owners of the company. If the debt is used successfully and if the operating profits are more than enough to cover fixed debt costs, shareholders income increases through financial leverage. Leverage ratios are related to the risk indicator. Companies that have high leverage ratios are considered more risky because there are fewer opportunities to protect creditors if the value of the company's assets falls. Leverage ratios are also a risk measure for investors, as companies that use high debt financing are the most risky investment object. If the value of assets falls or if the company were to experience a decline in sales and losses, share capital is destroyed more quickly for companies that have higher financial leverage than for companies that do not use financial leverage. Leverage ratios are different for different companies. Within an industry there is an optimal ratio of debt to total assets. Finding the optimal capital structure is important to maximize the value of the company.

2.1 Factors Influencing Decisions for Debt Usage

The managers must use their own estimates and judgments in determining the exact optimal capital structures. The evaluation analysis includes several different factors given below. In a situation a certain factor can be of great importance. In another situation, the same factor may be irrelevant.

1. Conservatism of managers

Managers are more conservative in using borrowing than shareholders would like.

2. Attitudes of lenders and Evaluating Agencies

Despite a manager's own analysis of the proper borrowing for his company, it cannot be doubted that the attitudes of lenders and rating agencies are often important determinants of financial structures.

3. Control

The impact of debt on the management control position of a company can also influence the decision of the capital structure. The judgments related to control do not necessarily suggest the use of debt or equity.

4. Asset structure

Companies, whose assets are used as collateral for loans, tend to use debt somewhat in excess. Thus, real estate companies tend to use a lot of borrowing. A firm’s tangible assets can be considered collateral to insure lenders from borrowers’ risk. The "tradeoff" theory predicts a positive relationship between the leverage ratio and the firm's tangible asset level. (Huang&Song, 2006) suggested that firms with less collateralized assets should use a higher level of debt to monitor managerial activity even if the cost of debt is high. This implies a negative relationship between the vulnerability of assets and leverage, a theory which has been confirmed by the results of (Sheikh&Wang, 2011)This study measures vulnerability as the ratio of net fixed assets to total assets (Friend&Lang, 1988)

5. Companies with growth rate

Fast-growing companies tend to use more debt than slower-growing companies.

6. Profitability

Companies with very high rates of return on investment use relatively little debt.

According to various theories, profitable companies tend to maintain lower debt levels because they are more capable of generating sufficient funds in a short time and as effectively as possible from internal sources in order to meet costs of projects which show the inverse relationship that exists between profitability and the leverage (Rajan&Zingales, 1995). (Jain, 2003) emphasizes that profitability is insignificant in determining the capital structure. On the other hand, the high ability to pay debts arising from debt, a factor which is generally taken into account by every lender, is a good determinant of the firm's profitability, as it ultimately measures the capacity of the firm to borrow. It is thought that more profitable companies find it easier to add debt level to their capital structure. According to (Rajan&Zingales, 1995) the ratio of operating income to total assets has been used as an approximation and measure of profitability.

8. Taxes

Interest is a deductible expense, while dividends are not deductible, so the higher the company's tax rate, the greater its advantage in using debt. (Jain, 2003) argues that the existence of deductible expenses for tax purposes to provide an alternative means a reduction in income taxes. Therefore, in some literatures an inverse relationship has been found between tax protection and debt. Contrary to the results of the above literature, (Merollari, 2012) found a positive correlation between tax protection and the degree of debt utilization.

9. Size

Various literature shows a positive relationship between firm size and the degree of usage of financial leverage, with the rationale that the larger the firm, the greater the diversification

opportunities which bring about more stable inflows, less possibility of failure and more exploitation of economies of scale in the issuance of securities. Eventually, larger firms may issue lower-cost debt than smaller firms. In this case, we can expect the firm size and the debt utilization rate to be positively correlated. Empirical studies conducted by (Rajan&Zingales, 1995) generally argue that debt utilization rate is positively correlated with firm size. On the other hand, some of the studies conducted by (Myers, 2001) concluded that there was no systematic relationship between firm size and overall debt ratio. However, (Huang&Song, 2006) argue that there may be less asymmetric information about large firms, as these firms tend to provide more information to foreign investors than small firms. The results of several studies revealed a negative correlation between firm size and debt ratio. According to (Rajan&Zingales, 1995) the natural logarithm of net sales has been used as an indicator of firm size.

10. Industry classification

(Huang&Song, 2006) among others, show that industry classification affects the capital structure of firms. They noted that generally companies operating in the same industry will have similar leverage ratios while the ratios of the latter are different in different industries. Empirically, the regression results clearly show that the industry effect is important to explain the capital structure and that there are changes in the capital structure of firms operating in different industries. Therefore, the capital structure is expected to change between different groups of firms operating in different industries in Albania.

11. Liquidity

From the literature review, the firm with high liquidity will borrow less. It is a fact that a firm with the most current assets is expected to generate more internal flows which can be used to finance its operational and investment activities. Thus a negative relationship between liquidity and leverage is to be expected. On the other hand, trade-off theory suggests a positive relationship between leverage and liquidity because the high liquidity ratio reflects a firm's greater ability to meet its short-term liability. (Myers, 2001) suggests that liquidity has a vague effect on decisions regarding capital structure.

CONCLUSIONS

The sources of financing the activity of companies can be divided into two main groups:

1) Internal resources
2) External resources

Companies prefer to use retained earnings (internal resources) for financing because they are cheaper. The point is that their amount is limited. Therefore, they must also use external sources of funding.

The ratio between internal and external sources of funding depends on several factors as follows:

1. The amount of funds needed
2. Profit rate of operations
3. Opportunity cost of Retained Earnings
4. Costs associated with external sources of funding
5. Availability of external resources for the company
6. Company dividend policy

The theory of capital structure does not provide an explanation for everything. It provides a valuable insight into the benefits of debt financing compared to equity financing. Short-term financing sources are used to finance short-term assets and are repaid within one year. Medium-term financing sources are repaid within a period of 1-5 years and are used to

finance medium-term investments. Companies use long-term resources to finance long-term projects. The sources of long-term financing include common stock, preferred stock and long-term debt (bonds). It is understood that the issue and sale of long-term securities have a cost. Debt capital includes all long-term borrowings of the company. The cost of debt is lower than the cost of other forms of financing. This is because lenders bear less risk than long-term equity contributors. Financial leverage exists when the company uses debt financing and when the company after securing the funds can earn more than it has agreed to pay for the sources of funds. The capital structure of a company should be built keeping in mind the risk. The capital structure is associated with a level of financial risk. The more debt financing and preferred stock a company provides in its capital structure, the greater its financial leverage and financial risk. Capital structure decisions are influenced by several factors such as: conservatism of managers, attitudes of lenders and rating agencies, control, asset structure, profitability rate, taxes and borrowing capacity and funding flexibility.

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