Capital structure in Albanian manufacturing corporations– The main factors which determine it

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Abstract

For every company, decisions made on achieving an optimal capital structure are important for its life cycle and economic profitability. Properly funded investments contribute to the creation of new wealth, which reflects a high added value in the market. A number of theories have been developed by specialists, in the field of finance and economics about the capital structure and its optimal level. In general, these theories came up to conflicting conclusions. One of these theories, developed by Myers and Majluf in 1984, is the "Pecking Order Theory", which states that companies choose to finance their activity in a certain hierarchical order, preferring domestic financing at first and if it is not possible, they will prefer to be financed through debt, and ultimately through new equity. This paper tends to analyze in which extent this theory of capital structure is applied in the Albanian reality of large manufacturing corporations. Through empirical analysis of the sample, it is analyzed to what extent manufacturing corporations taken in the study, choose to apply this preferential order in decision making between different financing alternatives. Through the inductive method used in the argument, it is concluded that "Pecking Order Theory" is widely applicable to large manufacturing corporations operating in Albania. They prefer domestic and debt financing rather than new equity. Based on the results, in the end are given some recommendations for large corporations, in order to see as an effective way of financing the issuance of new equity, or even debt securities, such as corporate bonds.

__Keywords:__ capital structure, pecking order theory, Albanian business financing.

1. Introduction

The process of corporate decisions on making various investments consists of comparing the present value of future cashflows with the actual cost of the investment, or comparing the expected return with the return required by the investment. Expressed simply, the investment process requires an estimation of the funds´ cost used to finance it.

This cost is related to the cost of capital and depends on the cost of different sources of funding. A corporation can borrow from a variety of sources and may issue preferred or common stock to raise its funds.

All sources of financing have a certain cost, so the question that naturally arises is: What is the best combination of debt and equity financing that minimizes the cost of corporate capital? This cost-minimizing combination of resources is recognized in the financial literature as the optimal corporate capital structure.

Defining and evaluating this optimal structure helps senior corporate management decide between long-term profitable investments. These decisions

are important for corporate´s life cycle and profitability. The right investments contribute to the creation of new wealth, which translates into a higher value of the corporate in the market.

Effective financial management of funding sources and the factors that determine the capital structure are important for achieving a good operational performance. Practically, capital structure has turned out to be an important influential factor in the corporate´s market value. A wrong decision that can be made regarding the capital structure can lead to financial difficulties and even to the bankruptcy of the company (Çekrezi, 2015).

"Capital structure describes the proportionate relationship between debt and equity" (Owolabi and Inyang, 2012). Debt consists mainly of long-term loans and bonds, while equity in the balance sheet includes share capital, stock dividends, reserves and retained earnings. Thus, a company has the opportunity to finance its activity through debts and / or through equity.

The cost of debt is lower than the costs of other sources of financing (cost of shares), because the company's lenders face a lower level of risk than its shareholders. This cost depends on factors such as: interest rate, corporate income tax and risk (Mayo, 2012).

The cost of the company's preferred stock depends on its dividend and the price that investors are willing to pay per share. From the company's point of view, the cost of preferred stock is higher than the cost of debt securities, as interest is a deductible expense for tax purposes, while preferred dividend payments are not (Ciceri and Xhafa, 2005).

The cost of common stock refers to the return required by potential investors, to encourage them to invest in the company (Cakolli, 2010). It is an opportunity cost, the return that investors demand from the company, to satisfy the potential uses of their money. Common stock is the most expensive form of equity.

Objectives

The objectives of this research paper are:

- Description of theories of capital structure, focusing on "Theory of Financing Hierarchy",
- General description of the way Albanian businesses finance their activity over the years,
- Analysis of the applicability of the " Pecking order theory " in Albanian manufacturing companies,
- Evidence of the causal link between funding sources, which confirms the application of the "Pecking order theory".

Research question

The main question raised in this paper is: Is there a practical application of "Pecking order theory" in the way Albanian manufacturing corporations finance their activity?

Hypothesis

The hypothesis of this paper is: The "Pecking Order Theory" finds practical application in the way Albanian manufacturing corporations are financed.

Methodology

The methodology used to validate the hypothesis is empirical, argumentative and inductive analysis. Empirical analysis was used to prove the relationship between various sources of funding. Through this method, the performance of financing indicators is analyzed over a period of time, for a sample of about 30 large companies operating in the manufacturing sector in our country.

The data of the sample is secondary statistical data, obtained from Monitor magazine, in an article listing the 200 largest companies (based on turnover achieved in 2019), in Albania.

Argumentative analysis was used to identify whether the theory has practical application in our study case.

Inductive method is the way of making broad generalizations from specific observations.From statistical analysis (regression model OLS) of the selected sample, I aim to reach a comprehensive conclusion for all manufacturing corporations operating in Albania.

For the collection and analysis of secondary data, I have relied on various scientific articles of the way large corporations in Albania are financed, in annual reports of the Bank of Albania, and in the data processed by the Albanian Association of Banks.

2. Literature Review

Capital structure remains an important research topic for corporate finance (Çekrezi, 2015). The pioneering work of Franco Modigliani and Merton Miller (1958) commonly known as the MM theory, on capital structure led to the development of several other theories bent on explaining the basic determinants of the capital structure in firms.

Modigliani Theory – Miller

This theory developed by economists Franco Modigliani and Merton Miller, first published in 1958, proposes that the market value of a company is irrelevant to its capital structure in a world where there are no taxes, bankruptcy costs and expenses related with the problem of agency costs or information asymmetries (Modigliani and Miller, 1958). The theory also concludes that, in a perfect ideal capital market, company is equally indifferent to choose between internal or external sources of financing. The market value of the company depends on the ability of its assets to generate profits and is independent of the policies it chooses to finance investments or to give dividends (Modigliani and Miller, 1958).

In the second proposition of the theory (Modigliani and Miller, 1963), in order to get closer to the economic reality, Modigliani and Miller considered taxes and proposed that companies should use as much debt as possible to increase their level of profits. The company has the opportunity to benefit from the use of debt, as interest is a deductible expense before taxes. Consequently, it will pay less tax when it uses debt as an alternative of financing, rather than its own capital (Modigliani and Miller, 1963).

This consequence of the MM theory (1963), was further developed and elaborated by the compensation theory or the "Trade off" theory (1977), which is described as follows.

Theory of compensation ("Trade-off")

Among all theories, the "Trade-off" theory, which is derived from the Modigliani-Miller (1963) theory (Iqbal et al., 2012) was the earliest and best known in explaining capital structure. This theory took into consideration the impact that taxes have, based on the MM study (1963), bankruptcy costs and financial difficulties (Warner, 1977), as well as knowledge from the agency costs literature (Jensen and Meckling, 1976).

Bankruptcy cost is a cost incurred when the expected probability of failure is greater than zero. Based on the "Trade off" theory, companies tend to require debt (Jalilvand and Harris, 1984), as they aim to maximize their return by "compensating" the disadvantages of debt with its advantages.

According to (DeAngelo and Masulis, 1980), among the advantages of debt, except tax benefit, can be mentioned as follows:

- Debt is a valuable signaling instrument by companies. Increasing the financial leverage ratio increases the value of the company in the market.
- Agency costs related to share capital are reduced by the use of debt.

- Debt reduces the management costs of the management team, by disciplining and supervising the company's managers.

Debt disadvantages (Warner, 1977), except bankruptcy costs, include:

- Managers, acting in the interests of shareholders, can shift investments to more risky assets and pass the costs to creditors.
- Managers can borrow even more and pay for shareholders' dividends.
- Excess debt leads to low investment.

The theory concludes that the capital structure is based on a compromise between tax savings and debt costs.

This theory also suggests that higher profitable firms have higher target debt ratio, because they would ensure higher tax savings from debt (Niu, 2008, p. 134).

Agency theory

Jensen and Meckling (1976) identified the existence of the agency costs problem. They argued that there are two types of agency costs: debt agency costs and capital costs. The conflict between managers and shareholders is related to the costs of the capital agency, while the conflict between managers and creditors is related to the costs of the debt agency. Agency theory concludes that capital structure is influenced by the company's managers, as they can act in their own interest, abusing with the company's resources, rather than working to maximize its value (Jensen, 1986).

Theory of signals

Following studies (Ross, 1977) have shown that companies with satisfactory market performance prefer to finance their activity using debt rather than issuing stock. Meanwhile, equity finance is interpreted by investors as a signal of management expectations for the future (Ryan and Winton, 1995). The management of a company issues new stock only when there is no other financing alternative, or when the stock is overvalued in the market (John and William, 1985). This fact is noticed by investors, who see the new stock prices as negative signals. As a result, stock prices begin to fall. In order not to have deflation nor to be financed by issuing equity, the top management of the company always tries to maintain an unused level of loans (John and William, 1985).

Indirectly, the work of these analysts (John and William, 1985; Ryan and Winton, 1995) supports the conclusions of the Pecking Order Theory, according to which, companies prefer internal sources of financing rather than external ones.

Pecking Order Theory- Financing Hierarchy

The first traces of the theory can be found in the empirical work of Donaldson (1961), who studied the financing practices of a sample of large corporations. He observed that the management strongly favored internal generation as a source of new funds even to the exclusion of external funds except when there is a great need for external financing (Donaldson, 1961). Even in this case, managers prefer financing through debt, rather than through the issuance of equity instruments such as preferred or common stock.

Pecking Order Theory suggests that firms have a certain preferential order for financing their activity (Myers, 1984).

According to Myers and Majluf (1984), the two main elements that explain Pecking Order Theory are:

1. Information asymmetry,
2. Transaction costs, related to external financing.

Because of the information asymmetry that may exist between the firm and potential investors, firms will prefer to be financed by retained earnings rather than debt, prefer short-term debt over long-term debt, and debt over equity (Myers, 1984). If information asymmetry increases, issuing new stock would be more expensive. Consequently, companies with high information asymmetry must borrow to avoid selling undervalued securities.

Myers (1984) in his paper emphasizes that transaction costs play an important role in capital structure decisions. The costs of transactions related to external financing are higher than the costs of internal financing (Baskin, 1989). Internal financing does not have any transaction costs. Therefore, the theory suggests that an optimal capital structure will not be achieved by the companies, but they will follow a certain preferential order in terms of the way of financing and will choose external financing through equity when the debt capacity is reached (Myers, 1984; Myers and Majluf, 1984).

Conclusions of the Theory of Financing Hierarchy ("Pecking Order"), analyzed by researchers around the world

To prove the consequences of the theory of financing hierarchy in practice, a number of works have been carried out by many researchers around the world. In the beginning, in most scientific researches, is argued the relationship between profitability and financial leverage and then the second conclusion of the theory, the relationship between debt and equity.

One research paper, which argues with statistical methods the inverse relationship between leverage and profitability is the one of Greek professors in the field of economics, published in June 2009 (Vasiliou, Daskalakis, Eriotis; 2009). This paper, entitled "Testing the pecking order theory: The importance of methodology", uses financial data from a sample of 107 companies quoted on the Greek stock exchange (ATHEX), and analyzes them through an empirical model.

The model has as a dependent variable the leverage ratio and as an independent variable the profitability ratio. Through the OLS regression model combined with cross-sectional and time-series data, the authors conclude that the independent variable (profitability) has a statistically significant effect on leverage and the relationship between them is inverse.

Another study, conducted by researchers and professors at the University of Taiwan (Li-Ju Chen, Shun-Yu Chen; 2010), entitled "How the Pecking-Order Theory Explain Capital Structure", examines the determinants of debt decisions for 305 Taiwan electronic companies that are quoted on the Taiwan Stock Exchange of 2009. The model used is multiple linear regression, which indicates that profitability and growth opportunities are two variables that affect the capital structure of companies operating in this industry.

According to the model, profitability negatively affects the capital structure, as companies prefer domestic financing to external financing (Chen et al., 2010). They use internal sources of financing to carry out their investment projects, and in case of shortage of internal funds, they turn to external sources.

3. Overview of business financing in Albania

The economic context of the country after the 90s until today

After the period of the 90s, our country went through the transition period throughout it experienced a series of major economic and social changes. With the transition from a centralized economy to a free market economy, the first private companies in the country began to establish (Çekrezi, 2015).

Significant developments in the period 1991-2000 were marked by the reforms taken in the finance sector, related with the privatization process of state-owned banks and the entry of new private banks into the market, which had a positive impact on the intermediation process.

For the period 2000-2015, the potential growth in the country slowed down significantly, especially after 2009, as a result of the decline in the contribution of all production factors. The reduction of investments in the country and the decline in the use of operating capacities in economy, transmitted negative signals in the labor market (Çeliku and Kodheli, 2016).

In recent years (2015-2020), our country has tried to undertake important structural reforms, which support equal economic growth, increase productivity and competitiveness, increase new jobs and improve governance (Baliqi, 2017).

On November 26, 2019, Albania was hit by an earthquake with devastating consequences. Among the efforts made to regulate the economic situation in the country, the COVID-19 pandemic further aggravated it. The World Bank and other international partners are working together to support the Albanian government in overcoming these challenges and implementing the country's long-term development objectives (World Bank Albania, 2021).

4. Empirical Analysis

As mentioned above, the purpose of this paper is to analyze through an empirical analysis, how applicable is the theory of financing hierarchy in the financing practices of Albanian manufacturing companies. To test or disprove the hypothesis raised in this paper, we will first analyze the relationship between the financial leverage ratio (debt / equity) and the profitability ratio (EBIT / Sales).

Relationship between profitability and leverage in Albanian manufacturing corporations

To test the relationship that potentially exists between profitability and financial leverage of Albanian manufacturing companies, these two ratios are analyzed through regressive analysis of panel data.

Presentation of the sample

The sample of manufacturing companies, taken in the study, consists of a number of 30 companies, due to the reliability of their economic data presented in the financial statements published over the years in the commercial register in QKB.

Sample examination

It is important to prove that we are not in terms of heterosexedasticity, as the OLS method would not be efficient in estimating the beta (ß) coefficient, an important parameter to see the relationship between the variables taken in the analysis.

The Breusch-Pagan model was used for the heteroskedasticity test. From its results, the sample taken in analyses is with zero heteroskedasticity, so there are no significant differences between the sample data. Under these conditions, we can

proceed further with the OLS regression analysis to test the relationship between the leverage ratio and profitability.

OLS regression analysis

Panel data analysis is performed through the OLS regression model. The model is a combination of cross-sectional and time series data to analyze the variables taken in the study (Deari, 2020).

The model hypotheses are given as follows:

H0: Profitability has no effect on financial leverage.

Ha: Profitability has an effect on financial leverage.

The model includes the independent variable, which is firm profitability at time t and the dependent variable, financial leverage at time t.

The regression equation of the whole population (all manufacturing companies operating in Albania), has the form:

Leverage = β0 + β1 * Profitability + ε

This equation has parameters ß0 and ß1, which are the real parameters of the population.

From processing the data obtained from the sample of 30 production companies, we generate the estimated linear regression equation, which is given as follows:

Leverage = b0 + b1 * Profitability + ε, where coefficients b0 and b1 are parameters of the selected sample. If we manage to find their values we can draw conclusions about the parameters of the population (ß0 and ß1).

Regression analysis of this data was processed through the Eviews software:

Dependent Variable: LEVA
Method: Least Squares
Date: 08/16/21   Time: 15:26
Sample (adjusted): 1 179
Included observations: 150 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.431475	4.403238	0.552202	0.5816
PERFITUESHMERIA	-1.480002	13.28129	-0.111435	0.9114

R-squared	0.000084	Mean dependent var	2.400796
Adjusted R-squared	-0.006672	S.D. dependent var	53.64425
S.E. of regression	53.82292	Akaike info criterion	10.82252
Sum squared resid	428742.1	Schwarz criterion	10.86266
Log likelihood	-809.6889	Hannan-Quinn criter.	10.83883
F-statistic	2.512418	Durbin-Watson stat	1.739678
Prob(F-statistic)	0,001914		

Resource: Data processed by the authors, through the eViews software.

As we can see, the coefficient of determination is 84%, which means that about 84% of the leverage variation is explained by the profitability variation. Also, the Fisher test (F-statistic) is high enough (2,512) to reject the null hypothesis (H0).

The estimated regression equation takes the values: **Leverage = 2.431- 1.48 * Profitability + ε**

β = -1.48, means that an increase / decrease of the independent variable (profitability of manufacturing companies) by 1 unit, decreases / increases the dependent variable (leverage ratio) by 1.48 units.

Model results

The null hypothesis (H0) raised in this model is rejected, as the results of the regression analysis show that profitability affects leverage ratio, and the relationship between them is negative, inverse.

Since the inverse relationship between the variables is confirmed for the sample taken in the analysis, we can reach comprehensive conclusions for the entire population (all manufacturing companies operating in Albania).

However, although one implication of the theory of financing hierarchy has been proven for the sample of manufacturing companies, the "debt-equity" relationship remains to be analyzed to reach a general conclusion on the applicability of the theory in albanian reality.

## Analysis of the "debt-equity" relationship in Albania

Another implication of the Pecking Order Theory has to do with the fact that companies prefer debt financing rather than issuing equity (Myers and Majluf, 1984). To test this implication, further in this paper we will analyze the main aspects of business financing in Albania, which affect the "debt-equity" relationship.

The organizational structure of corporations

According to the statistics of the form of organization, most of the companies included in the sample are organized as limited liability companies (LLC). More specifically, about 83% of them are organized as LLC and 17% as joint stock companies (data are presented in the diagram below).

Even if we make an analysis of the organizational structure of all companies operating in Albania, we will notice that most of them are organized as LLC.

Organizational structure of manufacturing companies

17%

83%

■ LLC   ■ Joint stock companies
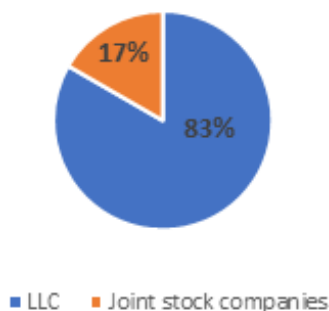
Resource: Data obtained from QKB, processed by the authors.

Quotation of manufacturing corporations on Tirana Stock Exchange

The capital market in Albania has not had the proper development to enable trading various securities, including companies stock.

Until now there is no company operating in the manufacturing sector quoted on the stock exchange. This is related to the current situation of the manufacturing firms and the economic context they operate (Bank of Albania, 2020). As a result, we have not had stock issues as an alternative for manufacturing companies to be funded and to invest in various projects.

General aspects of the business

General aspects are related to the existence of a vision / mission, strategy, business plan, observation structure as well as the prestige of the company (percentage of the market it occupies, age in the market, etc.).

The business development culture in Albania has lead to problems identified in business´plans and strategies. Companies organized with one or few owners are preferred over the cooperation of many shareholders (Deloitte, 2020).

Poor financial culture of administrators and management staff

Based on assessments conducted in the country (Deloitte, 2020), administrators and management staff of Albanian companies have little knowledge about the capital market, financial instruments and the use of this market as a way of financing their economic activity.

Financial reporting

Financial reporting analysis is one of the most important aspects for quoting companies on the Stock Exchange (Deloitte, 2020).

Potential investors are interested in having information on the long-term profit potential, growth rate and ability of the company to pay dividends. Therefore, it is very important to get the information correctly from the financial statements.

Companies that do not meet this criteria find it almost impossible to be quoted on the Stock Exchange (Zaloshnja, 2018).

What economic experts have identified in their analysis and research papers (Zaloshnja, 2018; Gjergji, 2015; Soko, 2013, etc.), is the work with "two balance sheets" of most Albanian companies that operate in our country. Trying to avoid tax liabilities, many firms end up with artificially inflated liabilities in their financial statements.

Lack of social capital

The actual conditions of our country reflect a low level of social capital, which further increases the difficulty of creating a large company, where co-owners are hundreds or thousands of shareholders (Zaloshnja, 2018). In general, Albanians who own a business, in the form of a limited liability company or a joint stock company, tend to cooperate with their relatives, cousins, or family members and not to collaborate with people outside their social circle.

Low competition level of companies within the manufacturing sector in Albania

Competition is an incentive that influences the decision made by companies to finance their activity through capital markets (Stock Exchange). But, in Albania the competition within the sectors of economy is not at those levels that companies feel the need to seek financing through it. Consequently, they prefer debt financing rather than issuing new equity.

5. Conclusions

Based on the above analysis, conducted in this paper, I come to the main conclusion that the "Pecking Order Theory" finds practical application in the way Albanian manufacturing corporations are financed. So, null hypothesis raised in this study is accepted.

The conclusions reached in the research paper are:

1. Albanian manufacturing corporations that have high level of profitability, have lower ratios of financial leverage (use less debt capital than those that are not very profitable). This means that highly profitable manufacturing corporations will generally choose to be financed with internal funds rather than external ones.
2. In cases where the manufacturing company does not have sufficient internal funds, it tends to use debt rather than new equity.

6. Recommendations

Based on the above conclusions I would suggest some recommendations, which, in my opinion should be implemented in order for businesses to see as an effective way of financing, issuing new equity or even debt securities.

Firstly, the improvement of the quality of financial reporting would increase the confidence of the investors and creditors towards corporations and their economic performance.

Secondly, in order to achieve a balance in the capital structure of Albanian companies, especially for medium and big companies, an efficient solution would be the development of the debt securities market, such as: medium and long term corporate bonds.

Moreover, large corporations, which have capacities to become part of the capital market, should consider hiring a more qualified, serious staff with full knowledge of the principles of modern finance.

Finally, the tax administration office from its part, should create a well-managed system where it can analyze and control in every time the activity of companies, imports, turnover achieved, and their financial statements, such as balance sheets and statements of income and expenses.

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