The Capital Market - a Possibility of External Financing of the Enterprises

Valentina Diana IGNĂTESCU[1]

[1]"Alexandru Ioan Cuza" University, Iași, Faculty of Economics and Business Administration, valentinadiana.ig@gmail.com

Abstract: This paper will examine how the firms can be financed through capital market. So, at first it will be analyzed the conditions which are required to a company to be listed on stock exchange. Then will be identified which are the advantages and the disadvantages of listing companies on the stock exchange. What this paper wants to see is if this type of arrangement is beneficial to the firms, especially in the current context, of the financial crisis, when many stock exchanges have collapsed, and what are that main problems that the companies face when they want to finance their activity trough the capital market.

Keyword: initial primary public offer (IPO), financial investment Service Company, "opened company"

1. Introduction

It is something normal for a company in development to look for financial resources cheap and affordable. These resources are very different, we can talk about the internal resources of financing but also about the external resources, among which there are synergies, according to the stage of company development and according to the attraction of its field of activity and the steps taken to identify and mobilize potential resources.

When the internal funding is not sufficient to meet all needs of medium and long term financing, like it usually happens, it is necessary to use the external financing in the form of bank loans, contribution from shareholders or other sources, like financing trough capital market.

Self-financing as an expression of the companies' effort comes from inside the company and it is basically sustained by the results of current activity and it is occasionally supplemented with exceptional resources. Self-financing capacity of the company is closely related to the dividend policy approved by shareholders. If the dividend policy is "tight" the self-financing covers a more needed funding.

But once the self-financing capacity is exhausted, the attention of the management of the firm is directed towards the external financing, which is represented mainly by bank loans, classical external financing very often used by companies.

The recourse to external financing through capital market usually occurs only after the company has exhausted its sources of self-financing and the access to bank loans. But it can be used also together with other forms of financing.

2. The Characteristics of the Capital Market

The capital market offers a wide range of financing options. It allows the confrontation between the demand and the supply of currency and it includes the financial market and the monetary market. In

turn, the financial market consists of two complementary markets: the primary market and the secondary market. On the primary market there are issued bonds and shares, which are securities to collect money on long term. The secondary market refers to the stock market, which is a place to exchange financial assets, shares and bonds which were formed on the primary market. This market has the function to collect money, to evaluate and ensure the mobility of the prices.
The financial market players are, on the one hand, the enterprises, the financial institutions and the state; which need capital and on the other hand, the holders of savings, including the companies in search of investment.

The firm must make a judicious choice between capitals, and the funding it seek is have to be well suited to the nature and to the duration of the operation to be financed, which is a safety criterion. In addition, the capital that the company is looking must be small and cheap, which form its profitability criteria.

3. The Firms Access to the Capital Market Resources

The conditions that have to be satisfied by a company to attract financial resources from the capital market are:
• The company must be established as joint stock company and at least 25% of its social capital has to be publicly owned;

• The company has to have at least 3 completed financial exercises;

• The proper capitals of the company have to register at least 2 million Euros (for the second category).

Based on these minimum conditions of access to capital market we must understand that not only the size of the company or its status is relevant, but especially the development prospects of the firm and the quality of management, translated by the firm's performance and especially by the confidence of shareholders and the third parties.

The first step in the admission of the shares of a company in Bucharest Stock Exchange is obtaining by the firm the status of "open society". The change of status is done through the company running an initial primary public offering (IPO) in which 25% of the social capital of the company after completion of public offering to be owned by the public. Using an initial primary public offering the company will increase its social capital by issuing new shares to be sold to the public (individuals and legal entities, Romanian or foreign) on the capital market. The conduct of such operations it is realized through a financial investment services companies with triple role in this type of operation:

• *advisory role*: being a complex operation with important implications for subsequent development of the society: the financial investment services company has an important advisory role both in terms of formalities before and during the offers development and for determining the characteristics of issuing shares, so which will be maximized the usefulness of this operation in terms of society;

• *role of investment*: the financial investment services company shall ensure the preparation and the distribution of issuing shares;

• *role of guarantor of the issue*: the financial investment services company ensure this role when they undertake to subscribe actions that have not found a buyer in the subscription period of issuing shares.

The operation of listing a company on a regulated market is based on the transfer of a part of the social capital to other legal and individual persons in order to ensure the liquidity of the shares after their admission to trading and retaining the decisional control of the company by its founders in conjunction with the attraction of resources from the financial market.

4. The Advantages of Admission to the Bucharest Stock Exchange of the Shares of a Company

Among these advantages we can mention the following important ones:
- *The access to the needed capital to finance the activity of a firm*

The existing financial resources on the capital markets represent a significant component of financing for companies that accede to the capital market and use its tools. Funding through the capital market is a much cheaper option; it outperforms the bank loans and is more accessible for performance companies due to market dynamics and the investor perceptions.

The attracted resources may be used for a variety of purposes including: growth and expansion, the reduction / elimination of existing debt, corporate marketing and development, capital for acquisition and diversification of holdings. Once the company was admitted to the stock exchange, the company's financing alternatives significantly increase. Thus, a listed company may resort to capital markets to attract capital through capital increases or bond issues.

- *The liquidity*

The shares of publicly held company are more liquid than the shares of a closed company. The liquidity is created for investors, institutions, founders and shareholders. Usually the institutional investors or holders of risk capital (venture capital) require that before recruiting funds, the company has to be publicly owned. Thus old and new shareholders may at any time to use the operation of investment or des-investment, depending on their opportunities or their needs.

Owning shares in a publicly held company can help his management to borrow more easily without the recourse to personal guarantees. In fact, the liquidity is the one important reason why the public owned companies are generally more valuable than the closed companies.

- *Increased evaluation*

The market value of a publicly owned company is normally significantly higher than in the situation where it remains a closed company. Thus, the conversion of a closed company in a public one has as a result the increase in the value of the package of shares held by its owners. The statistics show that the sellers of closed companies can receive on average between 4 and 6 times the net profits per share. By comparison, the listed companies are sold on average at 25 times the net profits while companies in the area of the top technology are valued even more than that.

The shareholders of a closed company, in the case of its potential sale, will experience a reduction in the value of its actions on the ground of "illiquidity" due to the lack of a public market for them. Thus, the listed companies often have a higher value than closed ones, but are similar in other points. The availability of some alternatives to attract capital gives to listed companies a higher leverage in its negotiations with investors, both individual and institutional. Many investors prefer to invest in listed companies because they have a "way out" which means that they will be able to sell their shares on the market. Many companies closed that would be bought have ranked for sale to higher prices.

- *Prestige*

A public offer of shares may help a company to gain prestige by creating a perception of stability. The status of a listed company has a pronounced positive effect on its activity and its competitiveness and stability. This perception may lead to the development of business relationships and to an increasing confidence among customers, suppliers and other third parties.

The founders, the co-founders (the initial and subsequent shareholders) and the managers gain prestige through alimenting the perception of stability. This prestige can be very useful when recruiting key - staff or when they undertake marketing activities for the target market. Where the control of the company is shared with the public increases the company's reputation and also increases its business opportunities.

Often a company's suppliers and customers are both, its shareholders and its business partners, an aspect that encourages growth and development of the firm. Once a company it is publicly owned its creditors and suppliers will watch it like representing a lower credit risk which will lead to the possibility of negotiating cheaper loans.

- *Personal wealth of the shareholders*

One of the most important benefits of listing companies on the stock exchange is that by this operation the shares of the company become more liquid offering rewards and financial freedom for the founders and the employees. A public market for shares provides a potential exit strategy for the investors and may increase the net wealth of shareholders. Even if these shareholders do not mark their profits by selling operation, the shares owned by them can be used as a real estate guarantee in a lending.

It is reasonable to consider that at the right moment it is recommended for the investors to mark their profit for the part of owned shares to acquire the necessary capital for portfolio diversification or for additional consumption. In this regard, the employees have two sources of gain: receiving a salary or the sale of shares.

- *Advertising*

The listed companies are included much easier in the attention of the main newspapers, magazines and periodic newsletters than the closed companies. The effective management of press releases, interviews and news about the company leads to the awareness of the company existence by the public and increase the demand for the company shares. A strong advertising campaign combined with media initiatives, may lead to the increase of sales and of the revenue.

The advertising derived from the character of listed company may encourage investment from the public, new business development and strategic alliances. The analyst's reports and the summaries of daily trading contribute to a deeper knowledge from customer and financial community so that by the public nature of the company its image can reach more easily in different environments. The process of transparency that commits the company in the moment of its market listing makes it known in a very large business environment.

The advertising that a listed company enjoy may draw the attention of potential partners or merger candidates. Since the company's financial situation is in the attention of market players through reporting requirements, the business relationships become stronger, both the existing ones and the one in the future. Many closed companies stay outside the focus of potential buyers, while publicly owned company status makes the process of evaluating of the company for possible "merger or acquisition" to be much easier.

- *Loyalty of the employees*

Many companies use their shares as an incentive to attract and retain valuable employees by so-called loyalty programs to company employees, enabling them the possibility to subscribe shares in the company where they work. This reward can be made more attractive when the company is listed. In stock exchanges the shares end up as a mean of attracting and retaining staff that are holding key positions in the society.

The distribution of shares to the staff indicates the welfare of the society and allows to the employees to become part owners of the company where they work, making them aware that the effects of their daily efforts are not only reduce to the level of salary but also lead to increased value of their shares. Thus, an optimal allocation of a part of the social capital to the employees leads to increase productivity, morality and loyalty. This type of loyalty is a method of connecting the employee's financial future to the success of the company.

5. Disadvantages of listed companies

Listing of companies brings not only advantages but also some disadvantages. The disadvantages faced by a listed company are related primarily to an additional effort from the management team, effort that is translated into additional tasks and additional costs.
The additional tasks are related to ongoing obligation to inform continuously the investors on the financial statements and on the main legal, technical and economic events occurring in the daily life of the company with influences on its activity.

The additional costs are founded as expenditure of the public offer, the fees charged by the regulated market admission; the maintaining costs and the costs of promote the trading, costs of management of the register of shareholders by the Central Depository or other costs. However, the level of the annual costs incurred by the company for its status of publicly owned company does not make unattractive the capital market used as a supplementary source of funding.

6. Capital market financing in the current financial crisis

Each economy period is characterized by the existence of specific needs both of the investors and of the companies. If during the stock exchanges boom it is normal for the listed companies to focus on financing by issuing shares, which have success among the investors, during the financial crisis, when the confidence in the stock market is low, most useful are the fixed income instruments.

The issuers of shares need now financing more than ever, and the investors from capital markets are more prepared to take the risk than the banking system, which works with caution and conservationism. Therefore, the fixed-income instruments market is likely to occupy an important share in the transfers from the Bucharest Stock Exchange because it already benefit from experience from the interwar period, and bonds are instruments that are suitable for the investment culture of Romanian investors, with adversity at high risk.

The evolution of this year of transactions on the Bucharest Stock Exchange shows the growing importance that investors have given to the bond segment. Thus, if in 2008 the value of transactions with bonds represented only 2% of the capital market in the period from January to September 2009 it increased by 13%, there are situations when the transfers with fixed income instruments have exceeded those of shares. And the current period, characterized by low financial resources and difficult access to bank loans, is suitable for bond financing of the companies, but this does not happen in a sufficient proportion because it amounts to a vocation on medium and long-term of the manager, which has to build forecasts for more than 5 years.

A condition to ensure the success of the bond financing is a good image of the issuing company. A high potential have the companies from the energy sector, from the state portfolio, and which have already asked for debenture on foreign markets and have an international credit rating and a certain size such as to ensure the investor confidence. Also important conditions are the company's organizational structure, the corporate governance, the existence of audited financial statements and the credit ratings.

7. Managers Preference for Financing the Activity through Capital Market

To see what number of the companies from the European Union countries resort to capital market financing we will analyze the results of the latest study of Flash EuroBarometer, no. 271 about the Access to finance of the firms from the European Union in the past six months. This study was made on 9.063 companies from the European Union, Croatia, Iceland and Norway.

Thus analyzing the Figure no 1 (Source**:** Flash EuroBarometer, No 271, September 2009, *Access to finance: Analytical report*, p. 77) in which are presented the most preferred types of external financing

to realize growth ambitions of the companies, we see that in Belgium, Luxembourg, Finland and Malta, more than three-quarters of managers who expected their company to grow in the coming years said that they would prefer to apply for a bank loan to realize these ambitions (between 77% and 86%).
Bank loans were the most popular type of financing in most other countries in the study. In only seven countries less than half of respondents select financing by bank loans: Poland and Romania (both 49%), Hungary (45%) and Estonia, Latvia, Cyprus and Lithuania (between 29% and 45%). Financing through the capital market is included in the other types of financing from the Figure no 1. So, we can observe that the managers use this type of financing in a proportion higher than 20% in a small number of countries: Slovakia, Cyprus, Romanian and Hungarian. In the rest of the counties analyzed less than 20% of the companies use the financing trough the capital market.

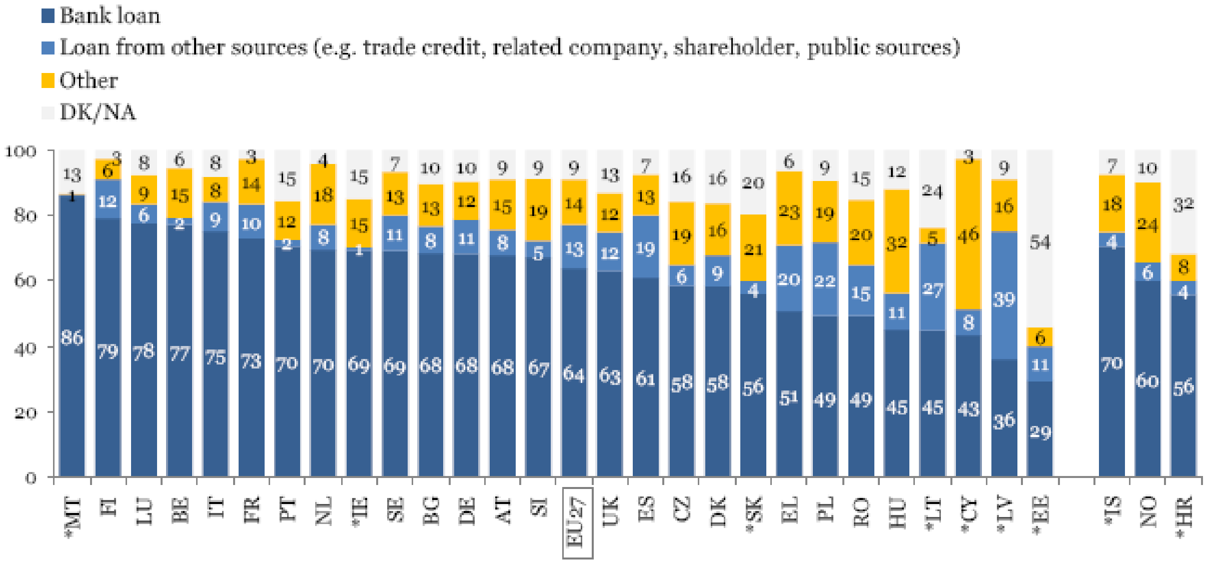

Figure 1 The most preferred type of external financing to realise growth ambitions

From this figure we observe that few companies use the financing through capital market. From the same study we observe also which are the main problems of the firms about the capital market, and why they does not use this source of financing although it brings a lot of advantages.

Very few (1%) non-listed companies in the European Union were aiming to get listed on the main list or an alternative, growth-oriented list of the stock exchange in the next two years. The proportion of companies with such plans was low across all countries in the study made by Flash EuroBarometer.

The main problem that the overwhelming majority (82%) of managers mentioned was that their firm was too small to consider being listed on the stock market. Other reasons, such as a listing being too expensive or a partial loss of control as a consequence of being listed on the stock market, were each mentioned by 1% of respondents.

The capital market is an important source of funding of the company, however not all firms have access to acquisition of their financing resources from this market. To resolve this problem there have been taken a number of measures. These measures are aimed to facilitate access of small and medium companies on the capital market, which will launch, among others, issues of bonds or commercial instruments.

8. Conclusions

Analyzing the history of financing the companies we may find that before the `70s the firms in most countries (except U.S. and Great Britain) were financed through loans from banks and other specialized financial institutions. To the financing by loans resorted about 80% of all firms from the market.
However, since the '80s, it gradually increased the role of capital markets, of the financial markets. After 1990 the external financing of the firms have begun to reduce using bank loans, and increasingly more companies were orientating towards financing capital market and other new sources of funding.

The financing on the capital market brings to the companies many benefits. Indeed there are some disadvantages to but they are minor in comparison with all the benefits obtained by companies when decide to be listed on the stock exchange. Moreover, during the current financial crisis, which was dominated by the collapse of some major stock exchanges worldwide the capital market from our country provided an interesting alternative to the companies, namely financing through bonds, which involve a risk much smaller than for shares.

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