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# **The development of capital market and its impact on providing alternative sources of business financing: Empirical analysis**

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## **Abstract**

We survey 500 business firms about the initial capital and its adequacy for business startup, how much the banking system meets the needs of business firms for loans, need for new sources of financing, if businesses possess sufficient information regarding the capital market, whether the lack of capital market impacts the access to finance, why financing with debt is not used by domestic businesses, and whether the issue of bonds will be used to finance businesses in the near future. The purpose of the study is to analyze the impact produced from the development of the capital market on providing alternative sources of business financing. Study hypotheses derive from the current reality and include causal links between study variables. Study covers the analysis of key variables determining the factors which bring out the impact produced from the development of the capital market on providing alternative sources of business financing. The research will involve both quantitative and qualitative approach. The chi-square test analysis has reported that for the observed statistics of the chi-square test, the null hypothesis - development of capital market will better meet the needs of businesses for alternative sources of funding, is proven, hence the hypothesis is valid, and the alternative hypothesis - although the capital market would develop, it will not affect the creation of new alternative sources of funding, is rejected.

*Keywords:* Capital adequacy; Sources of financing; Bank loans; Capital market; Debt financing; Survey

*JEL Classifications:* G20, G21, G30, G31, G32

## 1. Introduction

A key decision of the business firm financing is the funding of its activities. If funding is not efficient, it will influence the firm's capability to accept profitable projects, and this will affect the level of profit from its operations.

The main objectives of efficient and effective financial policy are: to provide sufficient financial funds; at the time when funds are required; and by the lowest cost. This helps to understand the relationship between financial decisions adopted by the financial management of the firm and the business firm owners. In order to be efficient financial policies, business firms should be informed about potential funding sources. In terms of developed financial markets, business firms can raise funds from more financial resources through financial instruments used to finance the activities of the firm.

Business finances are important, interesting and challenging. Are important, because decisions for capital investments in the modern economic environment can determine the success and sustainability of business firms in the future. Also, the success or failure of the company in most cases, depends on the ability to find the capital they need.

After the 90s, and especially after 1999, Kosovo has undergone a series of major economic and social changes. With the transition to free market economy, began the process of creation of the first private businesses and then companies. Companies need funding sources from the moment of creation and ongoing, to finance their growth, to fund investments in sustainable assets, long-term project financing etc..

The purpose of the study is to analyze the impact produced from the development of the capital market in Kosovo on providing alternative sources of business financing. This would help and energize the development of businesses community and economy in general.

Hypotheses to be tested in this study are developed based on the key components affecting alternative sources of business financing in Kosovo. Null and alternative hypothesis and two sub-hypothesis are established as follows:

$H_0$  → Development of capital market will better meet the needs of businesses for alternative sources of funding.

$H_1$  → Although the capital market would develop, it will not affect the creation of new alternative sources of funding.

Sub-hypothesis:

$H_a$  → Lack of information regarding capital markets will be the main obstacle to the use of bond issuance in the near future.

$H_b$  → Although there is no sufficient knowledge on capital markets, bond financing could be used in the near future.

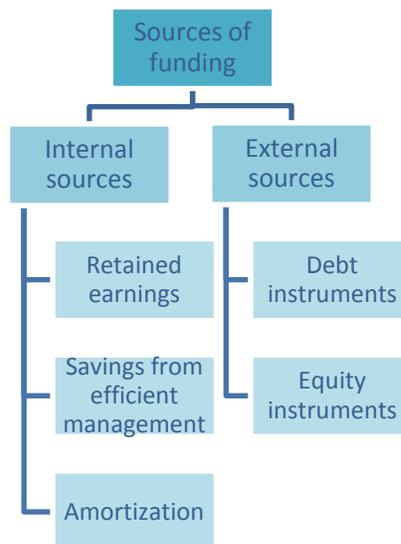
## 2. Sources of business financing: Literature review

Facilitating access to finance is essential to set up a favorable environment for the development of enterprises. In general, business firms in developing countries face numerous barriers to financing, although this problem is not unknown in the developed countries. Surveys of current and potential entrepreneurs suggest that obtaining adequate access to capital is one of the biggest hurdles to starting and growing a new business (Kerr & Nanda, 2009). Obstacles faced by the enterprises usually relate to high administrative costs, high collateral requirements and the lack of willingness of banks to lend to business companies. Increasing the level and the possibility of access to finance for business companies can improve economic conditions in developing countries by promoting innovation, growth of GDP and reduce unemployment.

Sources for financing the business firms can be divided into two main groups: a) internal sources, and b) external sources of funding. The finance literature documents that firms exhibit a clear preference for internal funds (i.e., retained earnings) over external sources of financing such as debt or issuing shares Brealey and Myers (1984), Brealey and Myers (1996), James and Wier (1988), and Pinegar and Wilbricht (1989).

Business firms provide financial capital from sources within the firm by retaining earnings generated (Figure 1). These funds represent a positive difference between the costs of establishing the business firm (transaction costs, interest payments, tax payments, payment of dividends, or renewal of fixed assets funds), and the income that it generates.

Figure 1. Sources of financing the business firm



Another source of internal financing that is often overlooked, are generated savings through more efficient management of working capital. This capital is melted in short-term assets and liabilities. More efficient management of claims from buyers, obligations to suppliers, stocks of

goods, and cash reserves, can reduce overdrafts from the bank account, and therefore interest charges, and increase cash reserves (Govori, 2005).

And another source of internal financing of great importance are the depreciation funds of the fixed assets and the equipment of company. Mayer (1988; 1990) has investigated the corporate financing patterns for Canada, Finland, France, Germany, Japan, Italy, the United Kingdom, and the United States, for the period 1970 to 1985 using the flow of funds accounts of these countries. His general finding is that internal finance is by far the dominant mode of financing in all countries and that financing patterns do not differ very much among countries. Following the methodology of Mayer (1988), Corbett and Jenkinson (1994) examined how investment is financed in Germany, Japan, the United Kingdom, and the United States. They find the overwhelming importance of internal finance in all countries covered in their study: Canada 76.4; Finland 64.4; France 61.4; Italy 51.9; Germany 80.6; Japan 69.3; UK 97.3; and USA 91.3, Mayer (1990), and Corbett and Jenkinson (1994). The implication of Mayer's conclusion is that there seem not to be a relationship between the financing pattern of firms in a given country and the prevailing corporate governance structures. This conclusion is at odds with the theory of incomplete contracts which exposit a relationship between corporate governance structures and financing patterns (La Porta and others, 1997).

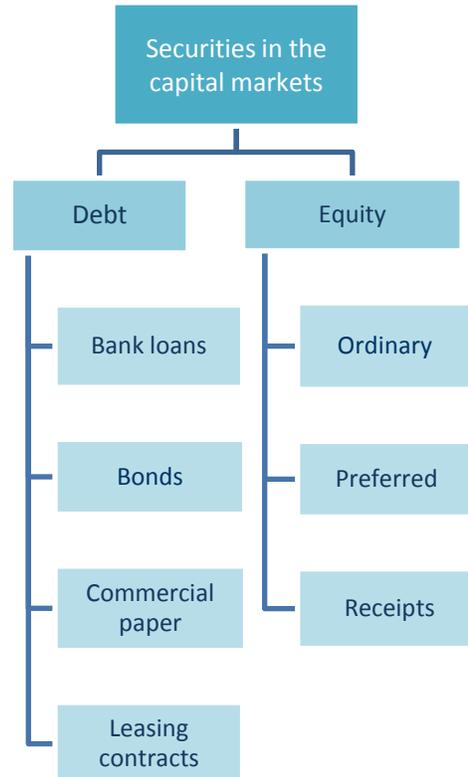
For the most of business firms, internal cash flows are insufficient to meet the total demand for capital. For this reason many business firms in certain periods of time should consider external sources of funding when they need funds to finance various projects, or when they plan the expansion of the firm's operational activities.

There are many external sources of funding which can be divided into two main types: funding sources through debt and funding sources through equity. External funding may also be classified in terms of maturity of the funds: short-term financing, and long-term financing; and in terms of institutional aspect: providing funds through financial markets (direct financing), or through financial intermediaries (indirect financing), (Figure 2).

Lack of capital or denial to financial resources was a major barrier for SMEs and entrepreneurs, which usually have to mobilize their own capital or their own resources to establish or expand their business (Govori, 2013). Also, SMEs in developing countries have difficulties in accessing bank loans as a consequence to the high risk for failing loans, low profitability and lack of collateral required by banks (Harvie, 2005).

For many SMEs from countries in the region access to finance and capital appear to be difficult. This comes as a consequence of weak banking institutions, lack of capital market and inefficient legal framework regarding credit and collateral assessment. Financing of SMEs and access to finance plays a crucial role in the growth process and development of the enterprises (WB, 2011).

Figure 2: External sources of funding



According to Nichter and Goldmark (2009) policies favor large enterprises while small enterprises face problems and difficulties to their development as a consequence of lack of access to finance. SMEs usually have difficulties to develop as a consequence of lack of collateral, high transaction costs and the inability to deal with complex financial institutions formalities. This is confirmed by our literature review according to which SMEs face difficulties in obtaining loans because they are seen as high-risk enterprises.

The role entrepreneurship plays in linking a country's financial market development to its subsequent economic growth is highlighted by King and Levine (1993a,b) and Levine (1997). Rajan and Zingales (1998) show that industrial sectors with a greater need for external finance develop faster in countries with deeper capital markets. Fisman and Love (2003) find that, in particular, startup firms struggle with overcoming weaknesses in financial market development, even where established firms are able to use trade credit as a substitute for formal financing. Guiso et al. (2004) examine local variation in the supply of credit across regions in Italy. They find that even in a well-developed and integrated financial market like Italy, regions with deeper capital markets promote the entry and growth of new firms and increase the propensity of individuals to start new businesses.

The level of competition between financial intermediaries can impact the terms of credit to startups as well as the degree to which capital is allocated to the highest-quality projects (Levine 1997). Stiglitz and Weiss (1981) outline that innovation within the financial sector that lower

information costs can have important effects on reducing financing constraints for entrepreneurs. Petersen and Rajan (1994) and Berger and Udell (1995) show that borrowers with longer banking relationships are less likely to pledge collateral, less likely to rely on expensive trade credit, and hence are less constrained in their investment decisions than firms with shorter banking relationships.

### **3. Financing of businesses in Kosovo**

This section considers financing of business firms in Kosovo. Although the business sector still needs many financing obstacles to overcome, internal and external, some examples of good practice can be found.

The enterprises surveyed in this study have started their business with internal funding. This happens almost to all new established business firms that have difficulties to access external financing. From the data obtained from the survey we understand that for entrepreneurs in Kosovo it is very difficult to obtain loans. Problems they usually face are lack of collateral and the unwillingness of banks to finance small enterprises, especially those new. But for business expansion, in our case enterprises have obtained loans, and this is because they have managed to prove their ability and to create their financial history.

Main business associations and business support organizations operating in Kosovo should represent the needs and interests of the business sector, to provide additional insights and guidance in order to facilitate financing business firms. Through this businesses should demonstrate creativity and proactive approach to the innovation in drafting of financial policies for their businesses. Currently they lack the capacity to fulfill their role in the implementation of an innovative policy in the field of business financing.

In this study we conducted a survey regarding the sources and forms of financing business firms in Kosovo. Based on the survey of 500 business firms, which was designed and implemented as part of this study, this section examines: the initial capital and its adequacy for business startup; sources of funding for business start; how much the banking system meets the needs of business firms for bank loans; uses of loans obtained from commercial banks; needs for new sources of financing besides bank loans; if business firms possess sufficient information regarding the capital market as one of the alternatives for their financing; whether and how much the lack of capital market makes it difficult business financing; in terms of maturity what types of financial resources are necessary for the business; how much is easy/difficult access to finance for businesses; why financing with debt is not used by domestic businesses; whether the issue of bonds will be used to finance businesses in the near future.

Surveyed business firms report numerous sources of funding and consider that those sources influence the pattern of development and business expansion. They also report barriers for finance and expansion of their businesses related to the lack of financial instruments, as a consequence of the lack of capital market in Kosovo and inadequacy of bank credit. Business firms report a higher level of cooperation with commercial banks, but also for many problems regarding the provision of their funding sources due to bureaucratic procedures on the approval of requests for loans.

They report limited use of external sources of funding, preferring to use internal resources by retaining earnings. Another source of internal financing are generated savings through more efficient management of working capital such are claims from buyers, obligations to suppliers, stocks of goods, and cash reserves.

#### **4. Research methodology**

The research philosophy we adopt contains important assumptions about the way in which we view the world (Saunders & Lewis, & Thornhill, 2007). These assumptions will underpin our research strategy and the methods we choose as part of that strategy. In part, the philosophy we adopt will be influenced by practical considerations. However, the main influence is likely to be our particular view of the relationship between knowledge and the process by which it is developed (Saunders et al. 2007). Because we are concerned with facts, such as the components affecting alternative sources of business financing in Kosovo, it will imply our research strategy and the methods. The research will involve both quantitative and qualitative approach.

Knowledge about the impact produced from the development of the capital market in Kosovo on providing alternative sources of business financing is based on what may be observed and recollected from the reality (survey), being objective about it, without any biases from data and respondents. Yet, survey results should be interpreted with caution because surveys measure manager beliefs, not necessarily their actions; survey participants may not be representative of the defined population of firms; and survey questions may be misunderstood by some participants (Graham and Harvey, 2001, p. 189). Study hypotheses derive from the current reality and include casual links between both study variables such as development of the capital market (independent variable) and provision of alternative sources of business financing (dependent variable).

To prove the hypothesis factual data are used with easily observable values obtained from the surveys with 500 business firms managers from different regions in Kosovo. Data will be encrypted and will be subsequently analyzed through the Statistical Package for Social Sciences, version 16. Mean, standard deviation, frequency and other statistical data will describe the characteristics of sample population. Hypothesis will be tested through Chi-square ( $\chi^2$ ) test, where the genuine statistical level is accepted at the quota of  $p < .05$ .

##### **4.1. Sampling and sampling procedures**

Owners and managers of business firms from different regions in Kosovo will be selected as a sample population. Probability sampling was used and the population selection method was 'systemetic sampling'. The number of respondents was 500 managers of business firms in Kosovo. In filling in the questionnaire, personal interviews and self-completed questionnaire were deployed. Structured questionnaires were employed in survey research. The aim of this approach is to ensure that each interview is presented with exactly the same questions in the same order. This ensures that answers can be reliably aggregated and that comparisons can be made with confidence between sample subgroups or between different survey periods. At all business firms we managed to collect data through the questionnaire designed for the

measurement of variables. In case such an interview was impossible practically, 'drop and collect' procedure then was chosen. This procedure was selected to get a high response rate. Not surprisingly, the response rate was 100% and all returned questionnaires were usable for analyses.

## 4.2. Data analysis

This study data are analyzed through SPSS statistical program, where the demographic section analysis of the questionnaire reported as study participants 500 managers of different business firms operating in different regions of Kosovo.

The most significant part of this study covers the analysis of key variables determining the factors which bring out the impact produced from the development of the capital market in Kosovo on providing alternative sources of business financing. Regarding T-test for null and alternative hypothesis, we analyse paired samples statistics which presents descriptive statistics (mean, number of data, standard deviation and standard error) for both variables; paired samples correlations that shows the correlation coefficient between two variables and the level of significance for two – fold test; and paired samples test which presents the results of our analysis. Statistics provided under the column Paired Differences are derived by calculating the difference between the compared values. Also are shown the average, standard deviation and confidence interval for the difference between averages at 95% confidence.

Regarding the null hypothesis ( $H_0$ ) and alternative hypothesis ( $H_1$ ) where:  $H_0 \rightarrow$  Development of capital market will better meet the needs of businesses for alternative sources of funding, and  $H_1 \rightarrow$  Although the capital market would develop, it will not affect the creation of new alternative sources of funding, the hi-square test analysis has reported that for the Observed Statistics of the hi-square test with a value of 43.027, at a freedom level equal to 499 and a security level of .000, which is specifically lower than 0.05, the null hypothesis: Development of capital market will better meet the needs of businesses for alternative sources of funding, is proven, hence the hypothesis is valid. Further, the alternative hypothesis: Although the capital market would develop, it will not affect the creation of new alternative sources of funding, is rejected.

Also, we test sub-hypothesis:  $H_a \rightarrow$  Lack of information regarding capital markets will be the main obstacle to the use of bond issuance in the near future, and  $H_b \rightarrow$  Although there is no sufficient knowledge on capital markets, bond financing could be used in the near future. We analyse descriptive statistics (mean, number of data, standard deviation and standard error) for both variables; paired samples correlations that shows the correlation coefficient between two variables and the level of significance for two – fold test; and paired samples test which presents the results of our analysis. Statistics provided under the column paired differences are derived by calculating the difference between the compared independent and dependent values. Also are shown the average, standard deviation and confidence interval for the difference between averages at 95% confidence.

According to the hi-square test for the observed statistics of the hi-square test 19.989, with a freedom scale of 499 and security level .000, which is lower than 0.05, it follows that the variables between them are linked, implying that our sub hypothesis  $H_a \rightarrow$  Lack of information

regarding capital markets will be the main obstacle to the use of bond issuance in the near future, is valid, and the second sub-hypothesis  $H_b \rightarrow$  Although there is no sufficient knowledge on capital markets, bond financing could be used in the near future, is rejected.

## **5. Conclusions**

This paper has discussed the need for development of capital markets in Kosovo in order to meet better the needs of businesses for alternative sources of funding. In this regard we made literature review on access to finance for business firms and conducted a survey with target group including 500 managers of different business firms operating in different regions of Kosovo.

Although the finance literature documents that firms exhibit a clear preference for internal funds (i.e., retained earnings) over external sources of financing such as debt or issuing shares, for the most of business firms, internal cash flows are insufficient to meet the total demand for capital. For this reason many business firms in certain periods of time should consider external sources of funding when they need funds to finance various projects, or when they plan the expansion of the firm's operational activities. Surveyed business firms report barriers for finance and expansion of their businesses related to the lack of financial instruments, as a consequence of the lack of capital market in Kosovo and inadequacy of bank credit.

We may conclude that in terms of alternative ways of financing, referring to the issuance of equity and debt securities, Kosovo is in the very early stages of their development. The use of these efficient methods for financing prevents particularly the lack of active markets corporate equity and debt securities. Factors affecting the lack of active markets for financial instruments are numerous: the fact that the transition from a mixed economy to a market economy occurred several years ago, Kosovo has no relevant experience in the implementation of such trading procedures, there is a lack of experience in managing these markets even if it is assumed that there are appropriate structures for their supervision and control, the reluctance of investors to invest in such schemes because of the related uncertainties and risks, and finally, the reluctance of businesses or corporations themselves to be involved in such financing methods.

In Kosovo, according to the research results the main source of funding remains bank credit. Despite the high interest rate, bank loans remain a highly used source by businesses, due to lack of funding alternatives.

Therefore, the use of these capital market methods would be very profitable, for joint-stock companies, to investors, but also for the economy in general. Reliance on bank loans should not be the only solution for borrowing. Conditions imposed by banks are generally aggravating to companies and can harm the performance of their activity. The functioning of the capital market in Kosovo would bring positive effects not only for the country's businesses, but also for the country's economy. Experience has shown that economic growth is more stable and faster when capital markets operate. Also, this positive relationship has been confirmed in small economies. In developing countries there are dozens of securities markets that operate successfully and help their national economies.

The development of the economy and the financial system imply the need to intensify the process of development of the capital market. Privatization of state share packages in the capital market, as well as various fiscal and legal initiatives are ways in which government can help the development of this market.

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