FINANCING OF BUSINESS ENTITIES IN REPUBLIC OF MACEDONIA THROUGH ISSUE OF BONDS

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Abstract

Financing of the capital market is in a close relation with the offer and demand for financial resources, i.e. the interaction between the entities with surplus and those with deficit of financial resources.

In the developed economies, the bond is very important instrument on the capital market, as a possibility for capital mobilization through their issuing by the business entities and as a possibility for investing free financial resources, from the investors' point of view. The knowledge of the advantages of this kind of security is the basic prerequisite for its increased implementation in the market, as an alternative for realizing profit by the two parties, i.e. the issuer and the investor.

The most usual problem for absence of this kind of security, besides the low level of capital market development, is the fact that the business entities are not informed about the possibilities offered by the bond, and about the advantages it has over the other securities. Because of that, it is indispensable each potential issuer to be informed what the bond is, which its basic elements are, the kinds of bonds, how the interest rate is determined, how the value of the bond is determined any time before its maturity etc.

The purpose of this research is to obtain clear picture for the advantages of and risks from capital mobilization through issue of bonds, to make analysis of the situation in R. Macedonia and to suggest measures for higher participation of this financing source into the business entities.

Key words: *bonds, issuers, capital market.*
JEL classifications codes*: G23*

1. Introduction

The business entities are constantly faced with a need of providing additional financial resources in their working. They can provide necessary financial resources by using banking credits, or by issuing long-term securities. In the developed market economies, in the structure of the business entities' financing sources, 42% belong to bonds, 22% to banking credits, 18% to shares and 18% to other sources of money. When choosing the appropriate financing sources, the business entity should take into the account the following factors: maintenance of optimal balance between its own and the borrowed capital, the degree of a risk on the investment for which the resources are mobilized, its degree of development and independence, and the tax policy and its instruments.

Respecting these factors, when selecting the capital sources, the business entity should always have the following things into the mind:

- When mobilizing financial resources through an issue of shares, the capital structure will move towards the capital owner benefit.
- When mobilizing financial resources through an issue of bonds, the capital structure will move towards the loan capital benefit.

2. Literature review

A debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate. Bonds are used by companies, municipalities, states and U.S. and foreign governments to finance a variety of projects and activities. Bonds are commonly referred to as fixed-income securities and are one of the three main asset classes, along with stocks and cash equivalents [1].

When companies want to expand their operations or fund new business ventures, they often turn to the corporate bond market to borrow money from investors. A company determines how much it would like to borrow and then issues a bond in that amount. Investors that by that bond are effectively landing money to the company according to the terms established in the bond offering [2].

Amongst a range of financing methods, bonds - transferable debt securities - have been an extremely important, reliable, and cost effective source of financing for companies around the world for decades [3]. The market disruptions of 2008 and subsequent years underlined the critical role they play in transmitting finance around the world to enterprises in the real economy, generating growth, employment, and prosperity. Bond markets for non-financial-services corporate are growing. They have increased in importance since 2007 (Dialogic statistics, Graph 8: $600 billion issued in 2007; $1.2 trillion in 2011; $1.8 trillion in 2012) as bank lending has declined (Graph 10: $4.5 trillion in 2007; $3.5 trillion in 2011; $3 trillion in 2012). They are expected to be a substantially more important tool for the economy going forward.
Bonds offer a range of advantages for investors. The biggest advantage of investing in bonds is that there are very less chances that you will lose out on your investment. So, people who do not believe in taking undue risks with their money should invest in bonds. People, who are nearing retirement and thus, cannot afford to risk their hard-earned money, will find dependable bond investments very suitable.

When compared to other safer forms of investments, such as saving accounts in banks, bonds pay a much higher rate of interest. So, instead of keeping money in a bank, people can invest in bonds and earn a good interest rate. Secondly, with bonds, there is no anticipation and anxiety over when the principal amount will be paid or when the interest will be received as everything is pre-decided and the investor is aware of the maturity date and the time when interest is due on his investment. Thus, bonds do not need constant monitoring like some other investment instruments. Lastly, certain bonds, such as municipal bonds, can sometimes be exempt from income tax. This adds on to the profits earned through them [4].

Bonds are unique compared with other investments such as equities in that a given return stream is well defined due to the highly certain income stream. As a result of this dependence on income, bonds are uniquely affected by movements in interest rates. Rising rates lead to higher yields and lower prices (i.e., capital losses) and vice versa [5].

3. Financing by an issue of bonds

The business entities can satisfy the need for long-term financial resources on the primary market by an issue of bonds. By issuing bonds, the issuer gets additional financial resources, but at the same time it is obliged to pay off the borrowed amount and the interest rate to the possessor (the creditor, investor) as per the prior exactly defined conditions.

The procedures for issuing are highly formalized and standardized independently of the issuer's characteristics, first of all to protect the investors' interests. Namely, each business entity cannot be the bonds issuer. In fact, the potential issuer is obliged to submit a request for getting permission for issuing bonds, to the authorized state body. Together with this request, an opinion on the business entity solvency is submitted as well by an authorized institution. Determining of the business entity solvency, as a basic prerequisite for issue of bonds, implies research and number of different analyses on the basis of many criteria, indicators and data, in order to form a picture of the entity financial and economic condition and future potential.

In the developed market economies where the bonds represent a big source of capital, there are many specialized agencies that determine the companies rating, among which the most known are Standard and Poor's Corporation and Moody's Investor Service. These agencies carefully examine the financial situation of the bonds issuer, the profit growth and its liquidity and situation on the capital market. Rating-agencies estimate on the basis of the ability for payments, consistency in performances, the issuer size, the ration between the debt and equity, the state of the working capital, etc. These indicators are estimated by the means of financial coefficients for coverage, profitability, leverage and liquidity.

Besides the company rating, the rating of bonds is determined, too. This rating depends both on the possibility that the enterprise will not pay them off, and on the provided protection in the loan contract in case of not paying off.

Each degree of lower level ranking means paying of higher interest rate. For instance, a successful company can issue 20-years bond with 6,5%-7% contribution up to maturity, due to the fact that it has AAA rating, while an enterprise which securities are ranked with B rating, for the same bond, can pay interest rate of 9%-10%. So, depending on the way of marking, up to Baa with Moody's or BBB with Standard & Poor's, these are bonds of high quality (investment grade). This rating is recommended for investors when they create their portfolio. Moving down words on the rating-scale of these two specialized institutions, leads to highly risky bonds or formally described as highly contributing bonds, or so called junk bonds. These bonds are the least recommended ones for the investors, because of too big risk they bring with them. Such kind of bonds has proved as a bad investment for many investors in the past, as a result of the fact that the issuers were not been able to pay off their obligation towards the owners of the previously issued bonds.

The biggest rating companies, when they make the rating, permanently perform the following activities:

- Collect information for the risk evaluating;
- Continuously monitor the ratings for assessing the necessity for its changes;
- Get information from the market on the client's rating.

The financing through the issue of bonds offers some advantages, such as:

- The issuer obligation is limited to the amount of the principal and the interest rate paid to the bonds owners;
- The financing through the bonds does not change the capital structure;
- Paying off the interest rate based on the issued bonds decreases the tax base;
- Simpler procedure for providing capital by issue of bonds compared to getting in debt through banking credits;

- The issue of bonds as a source of capital, allows the issuer to keep its autonomy and independence in decision making.

4. The bonds market in Republic of Macedonia

The capital market plays an important role in the financial market of each national economy, mainly in its development. Up to now, in R. Macedonia, the most important place has been occupied by the credit market, in which the banks have the main role. However, by establishing the Macedonian stock exchange, it has been expected to provide efficient, transparent and safe functioning of organized market of securities, diversification of risk with investors, through an offering of wide spectrum of securities, with different risk, control and protection of investors and a possibility for the business entities to be financed through issue of long-term securities.

The first issue of bonds in Republic of Macedonia is the issue of bonds for selective credits, issued on the account of NBRM. The aim of that bond was compensation of the selective credits of NBRM, which had been settled by unpayable bank's claims. The principal of these bonds (on which the interest rate is calculated) is 1.039.318.418,00 denars, that are due on 01.04 2020.The resources for paying off these bonds are provided by the Budget of Republic of Macedonia.

Another kind of state bonds, issued in Republic of Macedonia, is the bonds for foreign currency deposits. Namely, in order to pay off the foreign currency deposits to the people whose warrantor is Republic of Macedonia, a Law was passed (published in the Official Gazette no. 32 from 2000), which came into force on 21. April 2000. The Law stipulates the way and proceedings for paying off the foreign currency deposits to the people whose warrantor is Republic of Macedonia.

This Law regulates fixing of the value of all savings accounts together with the interest rate , up to 30.04 2000; conversion of all savings accounts into EUR currency, by applying a list of exchange rates of NBRM from 30. April 2000; complete paying off of all deposits up to 50 EUR and 3% of the deposit for those higher than 50%; the way by which the remaining deposit is transformed into bonds; the owners' information; the instalments and bonds interest rates paying off; trading and transfer of the bonds ownership, intentions for their use etc.

As most actual bonds in Republic of Macedonia, are the bonds for denationalization. The first issue of bonds for denationalization in Republic of Macedonia, in fact , was the issue of bonds for denationalization issued on 17.06 2002 with ISIN mark 4064585 den.01. The official trading and quotation of these securities on the Macedonian stock exchange began on 26.06 2002. These securities were issued as dematerialized ones, as per the nominal value which the claimer, on the basis of denationalization, receives as compensation. These bonds read on a name, and are issued in EUR currency and are transferable without limits. This first issue had total nominal value of 2.500.000,00 EUR. The interest rate of these bonds was 2%, which together with the principal were being paid off within the period of 10 years.

The second issue of bonds for denationalization was approved on the meeting held on 24.03 2003 by the Managing Board of the Macedonian stock exchange, as dematerialized securities reading on a name and transferable without limits, under the code RMDEN02,0 , at the total issue ammount of 38.100,00 EUR.

All ten issues of bonds for denationalization, with their total nominal value, are shown in table 1. [6]

Issue	Issue amount	First installment	First interest
1.	2 500 000,00	01.06.2003	01.06.2003
2.	38 999 198,00	01.06.2004	01.06.2004
3.	47 000 000,00	01.06.2005	01.06.2005
4.	58 000 000,00	01.06.2006	01.06.2006
5.	34 000 000,00	01.06.2007	01.06.2007
6.	18 000 000,00	01.06.2008	01.06.2008
7.	30 000 000,00	01.06.2009	01.06.2009
8.	23 000 000,00	01.06.2010	01.06.2010
9.	30 000 000,00	01.06.2011	01.06.2011
10.	10 984 398,00	01.06.2012	01.06.2012
11.	12 359 000,00	01.06.2013	01.06.2013

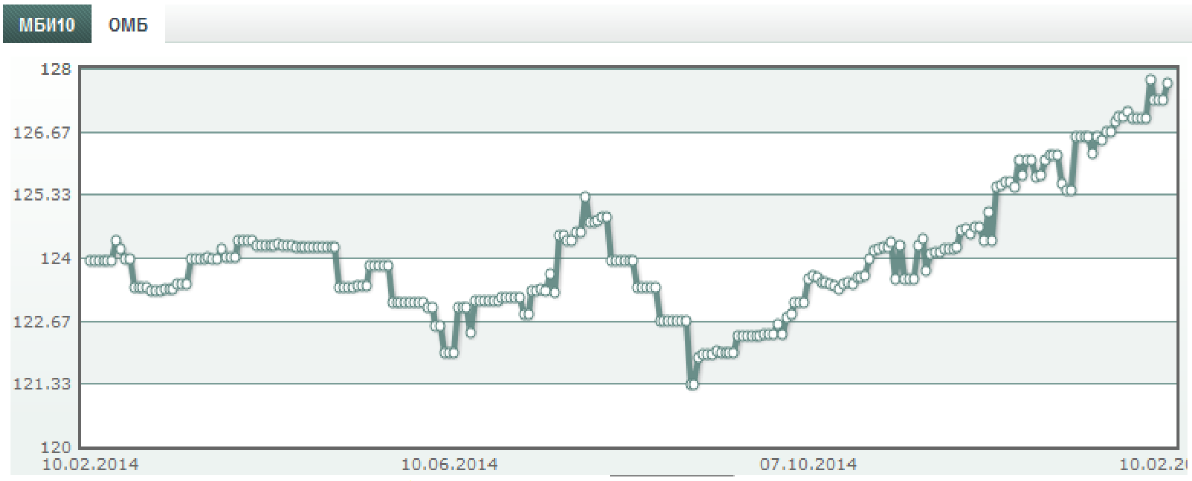
Source: http://www.cdhv.mk/default-MK.asp?ItemID=44
Table 1:Emission of denationalization bonds in nominal value

As it can be seen from table 1, realized issues of government securities have reached 12.359 million denars, which is more by 1.893 million denars, or by 18,1% , compared to the previous year. In 2013, 34 auctions of continuous government bonds on several maturities were realized.[1] [7]. About 80% of the total amounts of the issued continuous bonds are in denars with currency clause, while the rest are in denars. The twelfth issue of bonds for denationalization was realized too, at the total amount of 12 359 000 million EUR.

The basic indicator for the movement of capital market for bonds in R.Macedonia is OMB index. The OMB Index is calculated on the basis of the Methodology for calculating Index of bonds on Macedonian stock exchange – OMB is composed of listed bonds on the Macedonian Stock exchange , selected according to the criteria given in the Methodology . Namely, the Index of bonds on the Macedonian stock exchange includes the listed bonds on Macedonian stock exchange that have been traded at least 30 days before entering the Index and that have minimum a year up to their maturity.
The selection of bonds that can be put into OMB is made by the Commission for stock exchange index, having in mind the following factors [8]:

- Interest rate
- Bond maturity and
- Other factors

OMB index movement for the last 12 months can be seen on diagram no. 1 [8].



Source: www.mse.mk

Diagram no.1. OMB index movement from 10.02.2014 to 10.02.2015.

Besides the state, the issue of bonds has been performed by NLB Tutunska banka, as well. Namely, the first public bid for bonds in R. Macedonia was realized in 2008. Those bonds were issued for the needs of managing structural liquidity, for providing long-term sources for financing the bank activities and managing interest rate risks. The issue was realized with a percentage of success of 88,86%.

Therefore, the issue of bonds, as an alternative for providing extra capital, has not been practiced by the Macedonian companies. That is mainly due to the lack of expertise concerning structuring and promoting this kind of securities.

5. Research with a questionnaire (poll)

In order to find out why the bonds are not issued by the business entities in Republic of Macedonia as an alternative source for financing their work, a poll has been carried out. The questionnaire was realized on a representative sample of 61 business entities, and feedback was received from 48 of the respondents. From the quantitative analysis, good conclusions can be drawn, on which basis useful recommendations can be given.

On the first question: **Do you have separate sector within your firm that makes analysis of possibilities for financing capital market? -** from the polled 48 firms, only 4,16%, or 2 firms have separate financial sector which examines the sources of money that can be used for financing the current and developing projects.

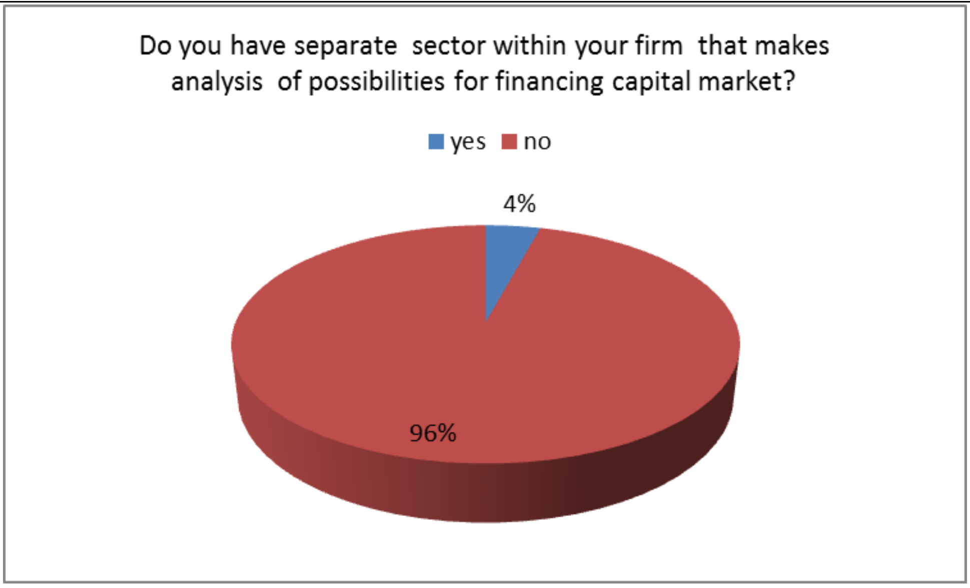


Figure 1: Do you have separate sector within your firm that makes analysis of possibilities for financing capital market?

On the second question referring to that **if they had investments in the several last years,** all polled firms gave positive answer, i.e. all of them had appropriate project realized in the last few years.

On the third question referring to **the sources from which necessary resources for financing investments have been provided,** for which it was allowed to select more options from the offered answers, 10,5% of the respondents- business entities answered that they had financed the realized projects by their own sources, 75% had used banking credits , while 14,5% used both sources of money.

Which were the sources from which necessary resources financing investment have been provided?	
1. They had financed the realized projects by their own sources	**10.5%**
2. They had used banking credits	**75%**
3. They used both sources of money	**14.5%**

Table 2: The sources from which necessary resources for financing investments have been provided

On the fourth question: **Do you know the advantages of financing by issue of bonds?** , 42% of the polled business entities answered positively.

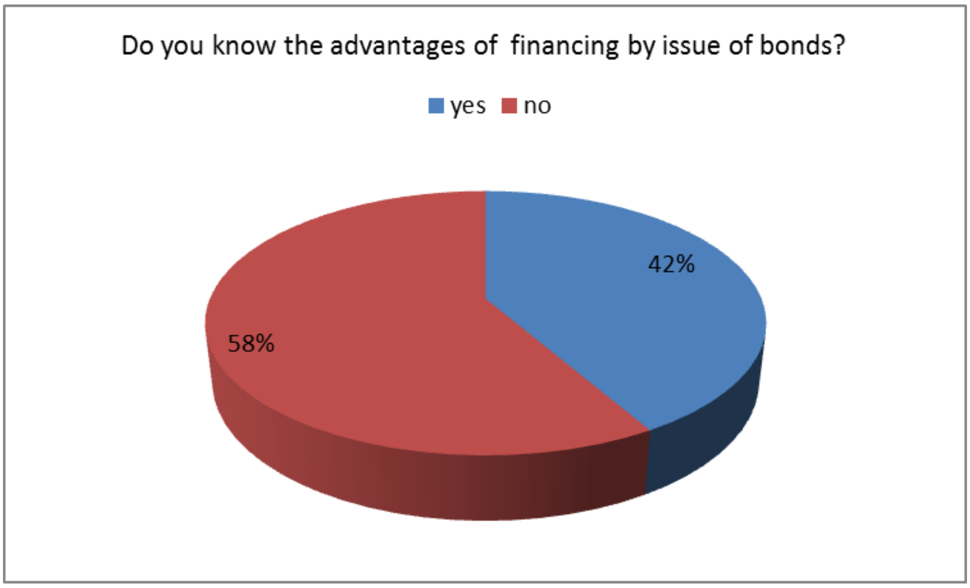


Figure 2: Do you know the advantages of financing by issue of bonds?

The fifth question referred to that **if the managers need additional education for providing necessary extra capital through issue of bonds -** 90% of the companies answered that they needed additional education by experts for the possibilities for and advantages of capital mobilization through issue of bonds.

On the last question – **Do you consider to mobilize resources through the issue of bonds? –** Only one company answered positively.

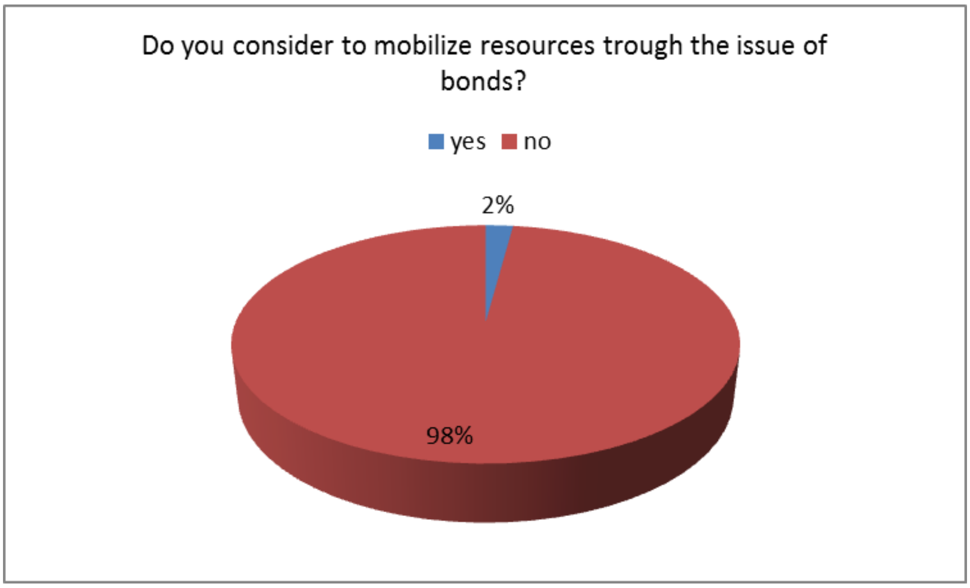


Figure 3: Do you consider to mobilize resources through the issue of bonds?

6. Conclusions and Suggestions for increasing capital mobilization through an issue of bond

The capital market in Republic of Macedonia is characterized with undeveloped primary market, limited liquidity of secondary market, a modest offer of investment alternatives and an expressed sensitivity of investors and their decisions regarding the economic developments in the region and internationally.

The basic aim of the research in this study , was to see the real situation with capital mobilization through issue of corporate bonds in RM.

The performed analyses of the examined subject here show that the business entities in Republic of Macedonia do not mobilize capital through issue of bonds at all.

The reasons for such a situation are result from:

- Ignorance of advantages of capital mobilization through issue of corporate bonds,\
- Managers' unwillingness for bonds issuing.
- Absence of a sector which would monitor the situation on the financial market.
- Public not sufficiently informed on the benefits of investing into bonds.

In order for the capital market in our country to function efficiently, especially to encourage business entities to provide the needed capital through issuance of securities, certain specific measures need to be taken:

- Organization of seminars and expert panels to educate managers about the opportunities offered by the capital market as an alternative way of financing;
- Formation of specific financial sectors in businesses equipped with experts to research capital market conditions and affect management in direction of making relevant decisions while choosing source of financing;
- Greater openness and transparency of companies who mobilize capital through issuance of securities, which will increase existing and potential investors' trust;
- Improvement of the established information system;
- Education of the public on the advantages of investing in long-term bonds;
- Establishing cooperation of the Macedonian Stock Exchange in greater international frames;
- Improvement of legislation and its efficient application;
- Improvement of the organizational and functional structure of the Commission for Securities and continuous improvement of its facilities and personnel techniques;
- Improvement and harmonization of capital market legislation with EU directives.

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