DISTRIBUTION OF INVESTMENTS BETWEEN COMPANIES THROUGH EQUITY FINANCING AND CAPITAL MARKET FINANCING

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Abstract. The financing of companies is a process with a decisive role in the implementation of their investment programs. The financing system that will apply the management staff in the implementation of the planned investment projects is important. This, in turn, has an impact on the distribution of investment between firms as a whole. In this regard, the present study is aimed at presenting the peculiarities of financing systems in the implementation of the distribution of investments between companies and the issues affecting imbalances in the distribution of investments, and relevant proposals and conclusions have been made on the issues under consideration
Keywords: company; financing; investments; capital
- **JEL:** D92; G32; L21

The equity financing and the capital market financing are conducive to an increase in the volume of investments. When equity predominates in the structure of investment financing, fluctuations in the distribution of investments are limited. On the other hand, these fluctuations in the external financing of the company's investments are significant and arise from the decisions of the management teams related to the use of capital market opportunities. In this regard, equity financing plays a decisive role in macroeconomic terms in the distribution of investments between firms.

In this aspect, the objective set in the article is: on the one hand, to reveal the advantages of equity financing over the financing of investments from the capital market, and on the other hand, to outline the guidelines and make proposals to reduce imbalances in the distribution of investments.

1. Peculiarities of the financing systems in the distribution of investments between companies

The distribution of investments between firms shows that equity financing, as well as the capital market, promote financial concentration. Greater merit in this process is inherent in the capital market.

The equity financing is a factor of the independence of firms and in particular of small and medium-sized firms, which allows them to avoid financial concentration. Equity financing is the only financial instrument that allows small and medium-sized companies to develop outside the empire of an industrial or financial group.

In terms of the distribution of investments between companies from different industries, the equity financing has certain advantages over the bank lending as part of the external financing. The allocation of capital between different types of investments is much better than what can be done through bank lending. With a well-planned capital expenditure budget, equity financing can channel to more productive investment projects and contribute to better internal allocation. This internal allocation through equity financing allows for a more efficient re-use of capital from stagnant or regressive industries to emerging industries.

Although the distribution through equity has many advantages (flexibility in the distribution of investments and rationality in the distribution of risks, as well as an effective conversion of certain assets) it must be recognised that it is not completely perfect. This is because even for large companies when expanding their activities it is difficult to have enough capital to implement their investment policy.

It should be borne in mind that in large firms, equity financing stimulates research, innovation and the development of new capital market activities to a greater extent due to their greater risky nature and commitment to decision-making. Research investments, the risks of which are high, can practically only be covered by equity financing, and not by recourse to bank lending or the savings of other economic agents. In order to invest in research or innovation, especially in times of crisis, equity financing is determined by the amount of retained earnings accumulated from previous periods.

When granting loans to companies in times of crisis, commercial banks mostoften use the expert assessment method, and the credit risk assessment covers business risk assessment and financial risk assessment. The factors in assessing business risk are the internal environment, the significance of the loan transaction, the relationship: "bank - company-client" and the quality of management. Financial indicators shall be used to assess financial risk. They are calculated for past periods or refer to the current period and the credit will be provided and serviced in the future, which does not allow with absolute accuracy to determine the financial situation of the borrower companies. On the basis of business risk and financial risk, a credit risk assessment shall be made that allows commercial banks to establish an internal credit rating system and identify potential borrowers.

The increased requirements in the context of a crisis in lending limit the access of small and medium-sized companies and hence the realization of their investment programs.

On the other hand, the formation of large portfolios of securities by economically strong companies is also a means of financing with their own funds, which contributes to the redistribution of undistributed profits, and from there to the investments among companies.

In this case, there is no separation between the turnover of financing with own funds and that of the capital market. Undistributed profits, i.e. the savings of companies, form turnover in the capital market. From the perspective of the mechanisms of investment distribution, they are not fundamentally different.

Such a practice of channeling capital from companies to the capital market is often criticized and pointed out as a disadvantage of equity financing. The arguments are related to the fact that the financial management of companies should reinvest these funds in production, and not direct them to the formation of a portfolio of securities. In defense of the thesis of external placement of funds in the capital market, the management of companies emphasizes that its actions are carried out with the necessary competence, motivation, awareness and with a high degree of rationality.

The allocation of a larger part of the profits for the purpose of forming and managing the securities portfolio by the management staff of the companies can be criticized from a social point of view, because in principle they do not fulfill the purpose for which they were created (See Rashkova 2017).

In terms of investment allocation, it has to be acknowledged that such resource allocation ends up with a better outcome. In this respect, it is inappropriate to criticise the firm's financial management for preferring not to invest systematically in its firm but to turn to external financing.

The management takes into account the current interest rate in the market, not to determine the boundaries between profit retention and profit distribution, but between internal investment and external financial placements in other firms.

The internal investment will be preferred if it is more profitable than the external placement of resources. In other words, internal investment will continue until the maximum efficiency of capital becomes lower than the market rate. Provided that the maximum efficiency of capital becomes lower than the market rate, the management of the company will orient towards external placements, whose yield will be at least equal to the market rate.

2. The Imbalances in the Distribution of Investments

The imbalances in the distribution of investment occur across firms, industries and economic regions. The favoured firms are from industries and regions that are already developed and that have made significant profits in the past. Their monopolistic position in the different sectors of the economy leads to large profits and allows large investments. Financing with own funds is favoured by these firms, allowing them to make large profits. In turn, the magnitude of equity financing allows them to use credit resources in the implementation of their investment programmes.

In a system of financing by the capital market, when in one branch of production the monopoly situation is the cause of the emergence of significant profits, new firms can hardly find capital, gain a foothold in the sector, enter into competition and destroy the monopoly position. The system of financing with own capital ends with maintaining and consolidating the resulting positions, increasing competition and reducing monopolistic trends.

Within the same sector, equity financing increases the divergence between better economically developed companies, which collect or increase their revenues and can without stopping improve their real estate assets, from less economically developed companies.

The impact of equity financing on economically weak companies is limited. In these, the profit achieved is small and the volume of the unallocated profit is insufficient to make new investments and modernise their existing assets to increase competitiveness and productivity. Reinvesting the scarce part of the realised profits is insufficient to avoid deterioration of the financial situation (See Velkov 2015).

In this situation, when financing with own funds, it is necessary to maintain the following position - weak firms with deteriorating financial condition must be restructured (subsequently, if they do not improve their financial situation - liquidated) or else be helped by a significant inflow of capital, which could only come from the capital market.

It should be borne in mind that in certain situations, as a result of equity financing, investments are concentrated in firms and sectors of already developed activities. In this regard, it can be a cause in these firms and industries to obtain assets that lead to an increase in production capacity that does not take into account the need of the market.

There are real cases in which companies earn significant revenues from their situation, but equity financing leads to the realization of excess investments and is defined as a waste of resources. On this occasion, it can be said that equity financing must be accompanied by a rational investment policy.

The general system of the equity financing and the capital market financing can guide the expansion of old industries by orienting them towards new activities that are not developed and that do not have the necessary resources for development. In the event of a shortage and limited financing with own capital, structural changes in investments will be limited. This will stimulate much more funding for traditional activities to the detriment of new activities based on innovation and technical progress.

Therefore, with limited equity financing, already developed activities and well-equipped firms are stimulated, concentrating and fulfilling their role with the monopolistic tendency to the detriment of new activities or activities underdeveloped in the past, which are not concentrated and subordinated to competition.

The equity financing, in practice, determines the general development of the economy in modern conditions - from fairly good realizations in some sectors of industry to slowing and holding back the renewal of fixed assets in others.

However, it should be emphasized that when managing investments, the management teams of companies must take into account both the equity financing and the capital market financing. The advantages of equity financing allow companies to avoid the requirements of the policy of strict control and orientation towards bank credit. An essential motivation for management teams in financing investments with their own funds is to limit government control. In this regard, some opponents of own funds financing go so far as to classify it as the cause of errors in the implementation of the investment plan. Against this background, it can be concluded that the common system of equity financing is above all an engine of economic growth by increasing the propensity for investment that it induces. At the same time, it can provoke a poor distribution of some types of investments, which does not give the same the expected average maximum profitability. This is proof of the existence and shortcomings of financing with own capital. But they are not as big as they seem at first glance. In any case, they are no bigger than those of the capital market, not as they are theoretically explained, but in their concrete reality.

3. The Influence of the Capital Market Structure on the Uneven Distribution of Investments

The determination of the limited role of equity financing in the uneven distribution of investments is related to the analysis of the capital market structure.

The structure of the capital market is far from consistent with the hypothesis of pure and perfect competition.

The reality reveals a picture quite different from the theoretical model, as the discrepancies stem from the imperfections of the market in the transition from theory to practice.

Many factors - from psychological to institutional - indicate that in the capital market, the absence of mobility and indivisibility can occur both from the perspective of demand and from the perspective of supply.

The lack of mobility is primarily explained by the inability of many small and medium-sized companies to access the market, and by their inability to obtain the desired financial resources at market prices. Only large companies have no problems with access to the financial market. What relates to the medium-term and long-term banking market, if most companies have access to it, the authority (financial condition and guarantees) of the companies is an essential element for granting loans. Small companies are in an unfavorable position. The commercial banks apply to them the “measure of unexpected losses”, which is a standard deviation of actual losses in recent years from their average, calculated using the following formula (Gallati 2003):

$$UL = \sqrt{PD(1 - PD)}\,.EAD.LGD \qquad (1)$$

UL - the measure of unexpected losses;

PD - the expected probability of default;

EAD - the amount of risk exposure;

LGD - the percentage of losses in case of default.

Therefore, when determining the amount of losses on a given loan, the attention should be directed to (Vatev et al. 2007):

- the risk profile of the debtor (counterparty) – it determines the probability of default by the debtor (PD), assessed over a certain period. It is calculated based on historical data. For some clients, the bank may obtain information on PD based on data from external independent rating agencies. When applying internal models for credit risk assessment, proprietary internal ratings are used;
- the risk characteristics of the credit transaction (credit product) – it influences the magnitude of the risk exposure (EAD) and the part of it that the bank would eventually lose in the event of default (LGD).

No company, even a large one, can borrow capital in unlimited amounts. Therefore, economic considerations deter some firms (mainly small and medium-sized) from the capital market. The lack of market transparency primarily affects the supply of capital. The shortage of economic information for lending firms and, in particular, for the majority of small savers reduces knowledge about demand, as well as the profitability of various investment projects. This inadequacy of information and of competence regarding credit transactions is usually associated with other psychological factors. It often ends with decisions that are not objective. With regard to supply, two major psychological trends have an impact on capital distribution:

• strict rules of credit transactions;

• large scale speculative operations.

The banks are used to complying with certain rules in the implementation of credit transactions, which are difficult to change even when the functions of production change or the expectations for the profitability of the invested capital, as well as for the investment markets in different industries. In this sense, the changes in the composition of demand do not automatically lead to the changes in the orientation of supply.

The opposite of this strictness (invariability) in the behavior of economic agents in concluding transactions consistent with an objective choice are large speculative operations. The capital market can reorient saving depending on the change in the composition of investments, as far as their distribution between industries and between regions is concerned, only as a result of large speculative operations. However, it is characteristic that speculation can have a beneficial effect within the limits of the structural change of investments, but does not predetermine perfect competition in the capital market, but only transfers to the new borrowers the monopolistic advantages that benefit the old borrowers. Against this background, the lack of indivisibility in turn presents monopolistic characteristics and expresses its existence both on the supply side and on the demand side.

In a market economy with a free market, the supply of capital is not oriented towards distribution among a large number of independent firms, but b it is concentrated in the hands of the managers of a limited number of large firms or financial groups. Even the capital offered by individual savers is often not borrowed directly by small and medium-sized companies, but is in the hands of a certain number of intermediary firms. In this way, these firms play the role of a center of redistribution of funds for investment.

4. The Immobility of the Capital Market as a Factor in Imbalances in the Distribution of Investments

There are companies whose financing is provided almost entirely by external resources. However, these firms lend each other capital (according to the different activities) with a wide variety in the percentage of expected investment returns. This shows that there is a wide variety of maximum capital efficiency between firms and industries and that the market does not define the Valras-Pareto type equilibrium. Most of the imbalances and distortions have been noted in relation to the apparent effects of equity financing on the distribution of capital market investments.

Similar to equity financing, the capital market creates zones of privileged investments, zones of overinvestment, and zones of negligible investment (Lambert 1992). These imbalances are rarely and only partially offset by the imbalances created by equity financing.

The capital market contributes to the creation of two major types of imbalances between firms, industries and economic regions:

- *type I: imbalances related to the belonging or non-belonging of the company to a particular financial group or economic unit.*

If the company belongs to a financial group, it directly or indirectly has access to the capital market. If the company does not belong to any economic or financial group, its market access is limited. In this case, the line of distribution of investments between companies is crossed by the limits of financial concentration.

On this basis, within one sector, the capital market finances companies related to financial groups that can receive resources and indirectly from the market to the detriment of other companies that do not have access to it even if their profitability rate is higher.

The numerous small companies, whose profitability is high, are limited in their development because the capital market denies them credit. Their competitors, who are not large in scale and sometimes have lower profitability rates but are connected to a certain financial group, surpass them thanks to the abundance of financial resources and a larger volume of investments (Gargarov, Kolev 2020).

The firms diverted from the financial market often find themselves susceptible to absorption by a group or by a single large entity, which would take them out of trouble, but at the expense of eliminating their autonomy. In this way, the market is established as a factor of monopolistic concentration. It concentrates investments in companies related to financial groups without profitability being the main criteria in this regard.

• *type II: imbalances related to the belonging or non-belonging of the company to some of the sectors of the economy.*

Some traditional industries, whose economic development is stagnant or in regression, can be financed by the capital market at the expense of new sectors. In turn, new sectors with high profitability and with high expansion are hampered by the immobility of capital markets. However, if these sectors become the subject of a large wave of speculation, they can attract a significant influx of capital, which "empties" the market, giving preference to the realization of a wrong investment.

Against this background, the specific analysis of investments through the capital market highlights its role in their uneven distribution. In this regard, when comparing the impact of the financing system on the distribution of investments - the system dominated by equity financing and the system dominated by external resources (the capital market), the accusations against equity financing for the uneven distribution of investments lose their strength. These accusations may be even less significant if a more in-depth analysis is conducted on the use of undistributed profits.

A serious concern in the area of undistributed profits is the fact that management teams prefer to invest in their own companies, because businesspeople rely primarily on themselves (Brochier 1952).

We have already talked about the extent to which the presence of retained earnings affects the economic estimates of management and in its investment decisions. This factor constitutes an essential element in the allocation of capital for investment, but its importance should not be exaggerated. In large companies, part of the financing of investments is carried out with funds from the capital market unlike small firms.

Ultimately, the company's internal investments and favorable reasons for external placement of resources are the cause of the differences in productivity. The company management whose investment decision is conditioned by "more efficient rationality" will prefer to invest in the company or to make an external placement of resources depending on the profitability of the investment and the interest rate. In any case, the scale of the companies' portfolio of securities testifies to the interest they expect from external investments.

If we compare the economic calculations of the managers of the companies, their decisions to use the undistributable profits, on the one hand, and the decisions to place resources, on the other hand, it must be recognized that in their totality the management decisions are taken with a higher degree of rationality.

Based on the above, when it comes to outlining the scale of the impact of equity financing and capital market financing on the global volume of investments, the following conclusions can be drawn:

First. The impact on investments through the equity financing is an objective element of the financial policy of any company. It is more effective than the impact of the capital market because it saves resources and strengthens the economic and financial independence of the firm.

Second. The impact through equity financing has two directions: a) impact on the volume of investments - as a result of equity financing, investments increase; b) impact on the allocation of investments, an impact that concentrates and directs resources to promising and profitable industries and activities.

Third. The financing is a process that is the engine of the company's investment policy - a policy that can cover the activity both inside and outside the company. Out-of-firm investing, which is essentially investing in securities, is an area that can be explored separately. Here it comes down to managing the securities portfolio, which can bring the company more resources than, for example, internal financing. In any case, the orientation towards the formation of a portfolio of securities is a consequence of the solid dimensions of financing with own capital and a prerequisite for the realization of the main goal of each company - growth of production and resources.

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