

THE CORPORATE GOVERNANCE AND THE OPTIONS BETWEEN EQUITY AND DEBT CAPITAL. CONSIDERATIONS ON ACCESS TO CREDIT IN ITALIAN REALITY (PART II)

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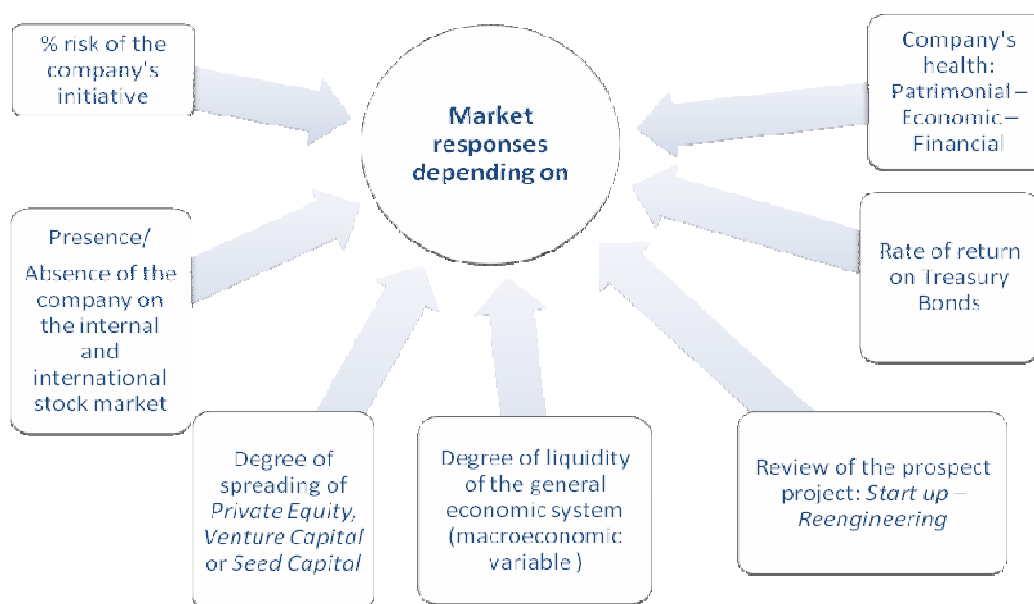
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1. Company needs and market offer

To make a careful and thorough research on future investments is certainly one of the most complex phases for the *governance* of the enterprise. Even the choice of the most appropriate financing has its importance for the success of the investment. The interaction company - credit institution can now benefit from its long history. Today the economic crisis of international proportions caused that relationship to be more labile and difficult, even if it remains always topical and important both for the local and international development. It is precisely therefore that we undertake to further identify, in addition to the requirements of the company, the offers as well as the market conditions which must be taken into account.

For the companies insufficiently prepared to make by themselves the investment chosen, the financial market offers a series of possibilities, so that these choices shall be identified based on the company's stability and balance.

The responses of the market and of the banking system - in particular - are linked to a number of factors that, without any pretence of completeness, we can summarize as follows:



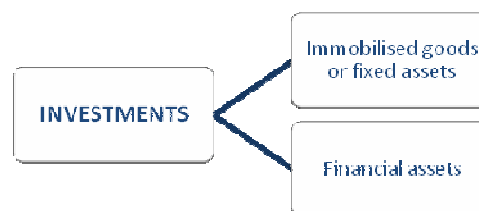
- Different solutions are proposed, according to the degree of risk given by the enterprise's initiative.

The lowest percentage of return on an investment can make it less exciting on the market, thus less funded.

- The presence or absence of an enterprise on the stock market may have a greater impact in order to attract certain investments of a financial nature (*Back Up Facilities, Merchant Banking*) or to become attractive to prospective foreign investors.

- One should neither rule out the level of development on the market of certain financial solutions. The investment programs in support of the companies in the *start up* phase, such as *Seed Capital* or *Venture Capital* - are highly developed in the United States and less common on the European financial market.
- On the financial availability present on the market we will speak in due time, when we analyze data issued by Banca d'Italia.
- The state of health of a company is strictly related to the ability to receive funding or to be able to allocate new shares on the market. As we stated in the first part of this work, the historical development and the current situation of an enterprise, whether defined in patrimonial, income or financial terms, cannot be separated from the future investment - hence the choice of certain companies to improve their attractiveness, ROE, by "technical" changes brought to the analytical plans.
- The rate of return on money market (government securities market) is of considerable importance. The investments and the savings are clearly conditioned by the evolution of this rate. It is not appropriate here to emphasize the debate, still high, on the competition, sometimes sharp, between financing the debt and the public deficit and financing private companies.
- Last listed here, but not in terms of importance, is exactly the type of investment required by company, whether it is in the *start up* phase or it needs a *reengineering* plan. This latter option is, more than the others, one that belongs mostly to the problems of *governance*.

First, the sector has to be restricted in accordance to the requirements of the company:



- *Investments in Real Estate or Fixed Assets or development of projects*

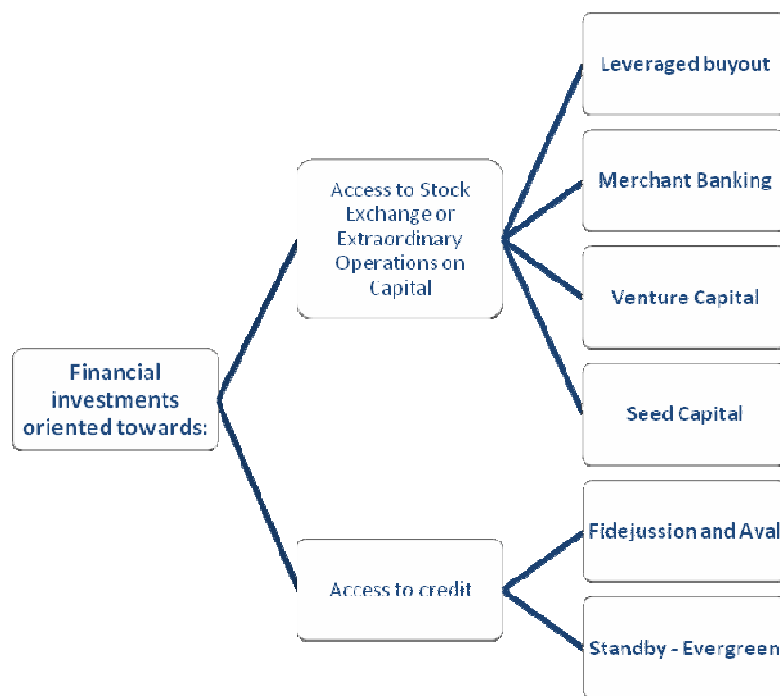
If at the basis of the investment is the need to purchase real estate, equipment or fixed assets useful for the operation of *reengineering* of business and also for starting the business, the company may use debt capital by Loan (predominantly Loan for Industrial Financing), Leasing (both Financial and Operational) or *Project Financing* (with the two expressions: *Project Financing* and *Project Management* where support extends to the very project - this last option is used mainly for investment in large projects).

- *Financial Investments*

If the needs are primarily financial in nature, the range of opportunities available is more diversified and more widely.

In turn, the financial investments must be classified according to whether they refer to companies listed or unlisted.

If the governance of the company has to accede to credit, they can choose between the traditional bank credit line by the formalities of *Stand By* and *Evergreen Financing* and the warranties provided by the credit institutions (Fidejussion and Endorsement or Aval).



If, instead, we refer to enterprises with a certain asset and income stability wishing to have access to stock market or initiate investments of incorporation and fusion, the governance will have the chance to choose between different financial products such as: *Leveraged Buy Out*, *Back Up Facilities*, *Shareholder Leasing*, *Merchant Banking*, *Venture Capital*; for *NewCo* a further solution has appeared in recent years, one able to provide sufficient financial instruments to enter the market. We here refer to the *Seed Capital*; By this practice - mostly developed in the U.S.A. – the companies in *start up* phase can have access to high-risk capital with a minority participation of an allocating institution. The investment does not special deadlines and allows the immediate launch of the company's investment project.

Therefore, the economic coverage to support the companies' investments - either in fixed assets or purely financial - has reached the level of sensitive development and specialization. Any requirement the enterprise might have, the market provides financial products coloured with the most appropriate and innovative hues. Well, once completed the enumeration of interventions, that, of course, is far from exhaustive, we ask a rhetorical, but necessary, question: is it, though, so easy for the enterprise to access the debt capital, i.e. different and more appropriate solutions provided by the banking and financial system? There are categories of companies for which the access to credit is more available and other that, on the contrary, suffer because of an endemic hardship to gain such access?

Looking into some statistics issued by Banca d'Italia we may give an answer to these problems.

3. Companies & Banks. Estimates on present, opportunities for future

The economic crisis, now of international dimensions, is rooted mainly in the exacerbated financial difficulties of the typical financial system. The efficiency of assistance given to companies by the credit institutions has forth undergone a slow but persistent decline. Simultaneously, enterprises - especially SMEs - have shown a rapid increase in the financing demand.

If we consider the year 2010, i.e. an intermediate year between the beginnings of the crisis - which, in the general opinion, is 2008 - and nowadays, we can notice a considerable increase in

demand for bank debt, following a significant increase in gross fixed investment by 3.5% compared to 2009.

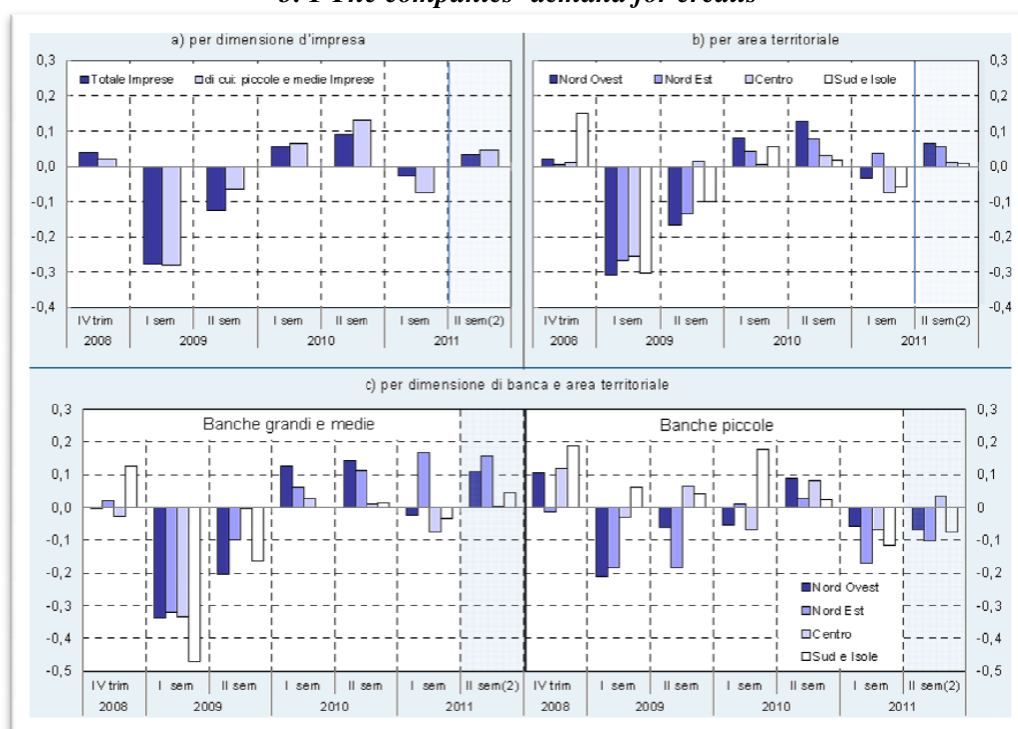
This process was the reflection of the modest growth in the industrial sector (0.7%, 0.4% only for manufacturing) and a faster increase in services (6.8%).

In the industrial sector this growth was stimulated by the acquisition of means of production, with firms achieving abroad more than two thirds of their turnover, thereby increasing investment by 6.3%, compared with a reduction of 0.4% with the remaining firms. Investment growth is perceived differently depending on the area: 3% in the North (over 4% in the Northeast) while a decrease of more than 3% is seen in the Centre and South. (1)

We must also note that 3.7% of them were related to the company's *re-engineering*.

This requirement for innovation and reorganization of the company increased consistently with that of the use of equity and with the growth of bank debt in a constant value of 7 percentage points. Considering the period between 2010 and 2011 we may see that there was a slight reduction in demand following a tightening of criteria for selecting the companies that should be financed.

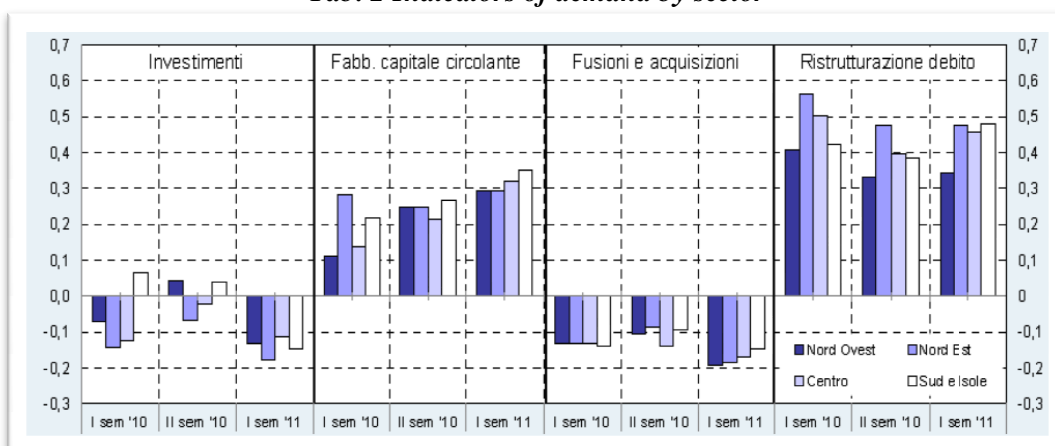
b. 1 The companies' demand for credits



Source: Banca d'Italia, Regional economies. Credit supply and demand at the local level

The phenomenon was particularly felt by SMEs and even more in the areas of Centre - South. The sector that was most marked by the recession was the construction sector, while services and manufacturing sectors remained mainly stable.

Tab. 2 Indicators of demand by sector



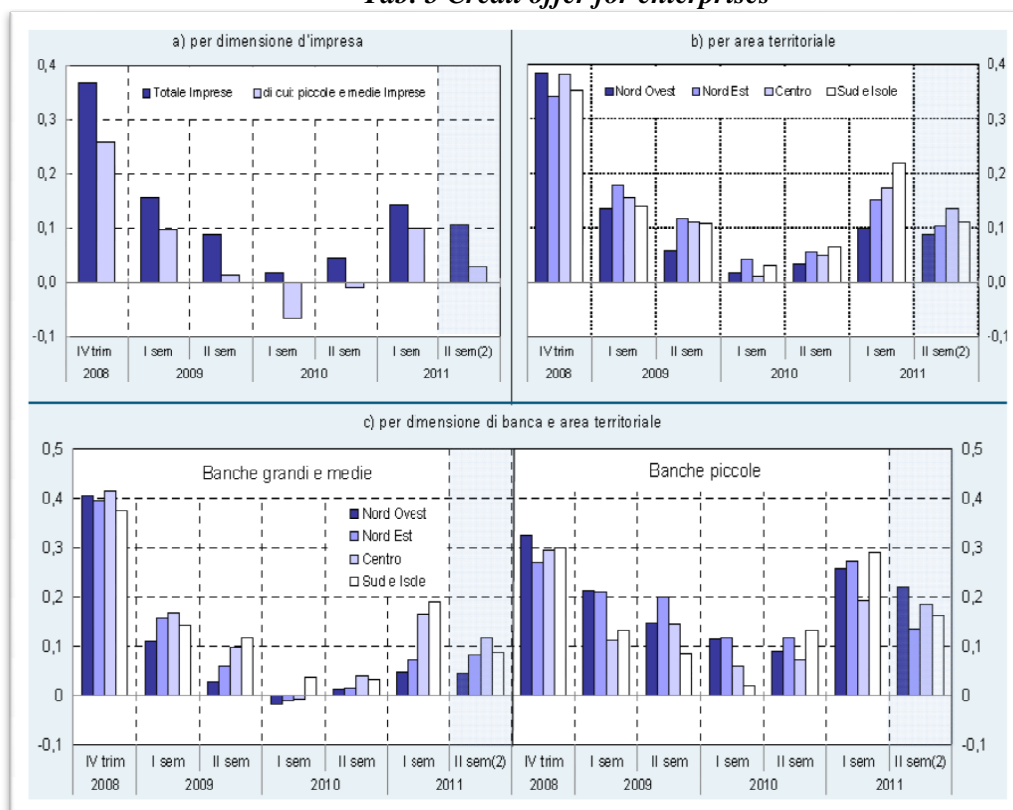
Source: Banca d'Italia, Regional economies. Credit supply and demand at the local level

Therefore, it was noticed a more evident increase in the demand for circulating capital as well as a demand for restructuring the financing, with milder and simplified conditions, compared with the light decrease in investments both in the North and in Centre - South and also the limitation of mergers and acquisitions.

To make a comparison with the Italian companies' request, we can consider the proportion of offer promoted by the banking system. Banca d'Italia helps us in this analysis by examining a sample of 400 banks spread throughout Italy. In the first and second half of 2010 the offer of the banking system recorded normal percentage values. However, in the period between 2010 and 2011 there have been adopted several policies to raise the spread on the investments considered the most risky. Also, this principle of protection applied by banks has determined various types of companies, particularly in the *start-up* phase or with little risk capital in general, to use alternative funding sources. Indeed, a slight decrease has occurred mainly in the supply to small and medium sized enterprises. This may have depended on the growing competition of numerous credit and financial institutions that have developed throughout Italy to try to meet different needs of companies - even the smaller, so to say "risky".

It is observable that where it was seen a lower credit demand by firms in construction, the response in percentage of supply from the banking system was positive and growing. In contrast, the service and manufacturing sectors proved to receive a lower offer. However, it never exceeded the range between -1 and + 1 percentage points.

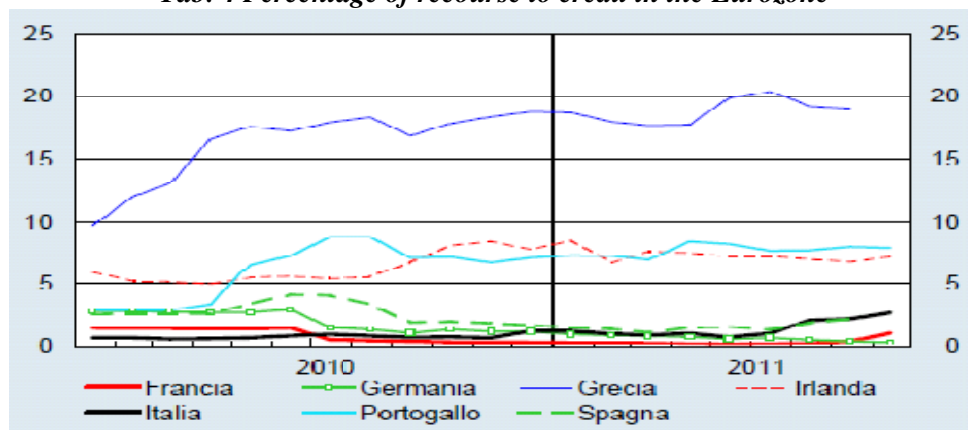
Tab. 3 Credit offer for enterprises



Source: Banca d'Italia, Regional economies. Credit supply and demand at local level

The crisis, from certain points of view announced and with systemic features (2) has become a global financial crisis and ultimately, as we are concerned, a crisis of the European debt, both of public nature and of the private sector, has involved businesses and banks as well. The graphs provide a better picture on the worsening of the situation of the credit demand from companies and of the banks' offer. Concerns and issues of the firms are confronted with and related to issues which show, more and more, macroeconomic features and dimensions.

Tab. 4 Percentage of recourse to credit in the Eurozone



Source: ECB and national central banks: Financial Stability Report, 2011

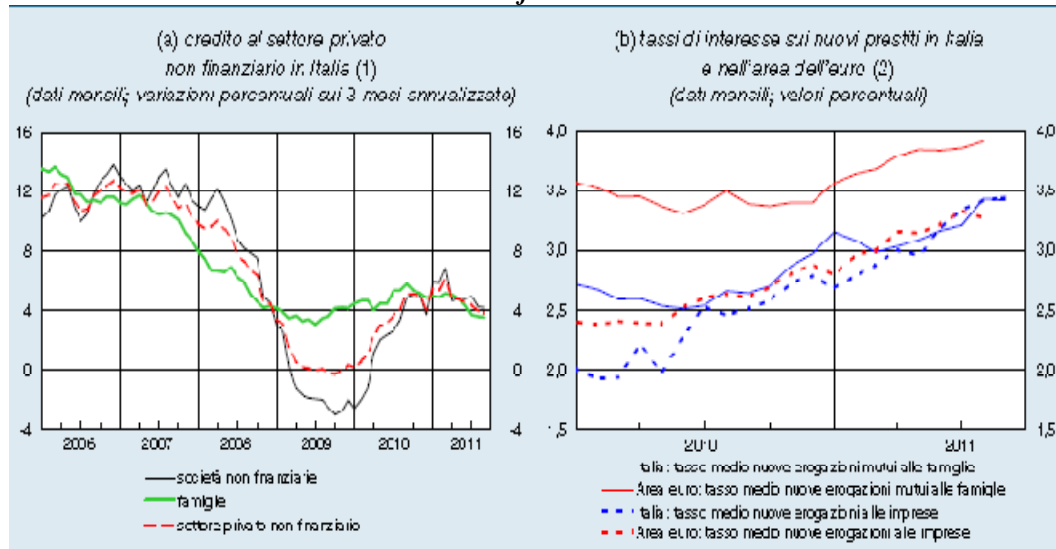
Indeed, Italy is not alone in facing such critical conditions. Estimates of the use of credit in the European area show this clearly. Indecision of banks to provide credit to SMEs is parallel to the distrust of the firm to rely on the old *partners* - namely banks - to which it was always shown a deep respect and trust in order to receive economic support necessary to open the new activities, to improve existing ones, or simply to overcome times of shortage as the present one.

A European aid able to improve the company-bank relationship has come through improved and sustainable supply of liquidity both in euro and in dollars.

In conclusion, we can hear the echo of the famous warning, perhaps more than justified: "*save the banks!*"

The uncontrolled evolution of interest rates on bank loans in Italy and in the euro area is more than significant an indicator of the vertiginous bank collapse into the unknown.

Tab. 5 The evolution of credit and interest rates



Source: ECB and the Banca d'Italia in: Financial Stability Report, 2011

How can banks subsidize companies while they have no cash themselves?

Hiding behind the cautious choice of providing financial coverage to the investments of the firm, investments becoming more and more risky, the banks can conceal another truth, far more serious.

"*It is so, if you think so!*" Luigi Pirandello claimed in one of his theatre plays.

In this brief and modest work we do not intend to support the objective impossibility of knowing reality, suggesting a completely economic relativism of forms, conventions, and exteriority and especially of the objective impossibility of knowing the truth in absolute terms or, if we like it more, to the end.

On the contrary, there is a doubtless truth and the very data and statistics published by the Bank of Italy and ECB support it.

As proof of this hypothesis, there are then the numerous European financial measures designed for rescuing banks from collapse. The ROE of 14 major banking groups would have remained at 4.5%, maintaining a worsening of the interest margins (2.8%). (3)

But, in some ways, it is hard to admit or confess openly the wrong choices, or at least the highly questionable ones, operated in the past by States and Governments, Banks, Corporate Management and Governance.

We can make serious observations and can find a likely truth about what happens, and along this research we could find merits and faults to all. Without exception.

Conclusions

After outlining a general framework of conditions in which companies and banks operate, we try without any pretence of completeness and very modestly, to make a conclusive analysis.

"The Agency Theory", which tends to involve managers and governance in the structure of society in order to raise their accountability to shareholders, ended by constituting one of the elements of the systemic crisis of today. While until the midst of the last century, a company had to grow, create jobs, put good products or efficient services on the market and only then make profits, in the mid 70s and throughout the 80s and 90s, the imperative was to make profit, "*tout court*" to increase shares' value, at any price. By doing so, there have been stimulated behaviours oriented towards short-term profit, the long term investments being penalized. With *stock options*, which ended by representing simple positions of the management and governance of the company, there were added paradoxical situations such as: the dismantling of companies, in order to sell their assets, with consequent dismissal of employees, the often unjustified fever "*Merger and Acquisition*" and so on, all these only to support the shares' price without actually producing and reproducing true wealth.

Could the financial and banking system stay off this philosophy of behaviour? Of course not. So one can easily deduce what happened. If there were claims difficult to achieve, instead of being removed from the balance sheets and entered to losses, which would have smoothened the image of that bank, with the result of shares' price depreciation, debts were sold to specialized companies, responsible for their collection, or, even worse - through the financial engineering of derivatives - the liabilities transferred have been the basis for their subsequent estrangement. We can legitimately ask whether in this case there was created real wealth or a privilege to speculation, covering at the same time the previous inefficiencies of banking and financial management. Or, moreover, might the internal and international banking and financial system have escaped from the underwriting of issuance or the purchasing of debt securities, even beyond its natural capacity? It can very easily be inferred that if the banking system is undecided between the need to strengthen their own heritage, the need to underwrite bonds or to make more innovative finance, the traditional activity that characterized the original banking function of crediting and financial assistance for companies was reduced gradually.

Disregarding the choices of economic policy that each country has pursued favouring either a policy of *deficit spending* or a very strict policy of the debt-GDP ratio and deficit-GDP, the explanation of which would lead us away from our current specific research field, the author of the present paper wishes to emphasize that there was found however a sensible move from what can generally be recognized as legitimate *profit* for the economic organization, towards the position of *rent*, so a gradual transition from a capitalism of a production nature par excellence to a capitalism of a financialized economy, or if we like that more, to a *rentier capitalism*, with all the consequences that derive from it: oligopolies emerged and developed in the shadow of the state's commands; mainly speculative activities and operations on real estate assets; speculative finance - oriented towards short and very short term profits; lack of interest in medium to long term economic views; public sector that often removed resources from the private sector to finance current expenditure and often unproductive ones to the expense of non-reimbursable public investments, consisting of medium to long term investment that would have created a virtuous flywheel of growth and development.

Today, Italian companies - and not only them - see that their economic success depends on two main factors: improving European economic pressure and return to more satisfactory credit conditions.

In our opinion, until we will get back to a better understanding of the needs of small and medium size enterprises, no reliable support can be provided to critical economic situation, at least in the

Italian context. A more stable situation can be reached through the cooperation between companies and credit institutions. This binomial has been since the dawn of Western economic the engine of economic development. This applies to the whole majestic analysis performed in quieter times by Schumpeter. This development process may look to the future through the victory over numerous technical challenges, but cannot escape the memory of the historic journey that had originated it.

A journey in which the small and medium enterprise was in the centre of progress also due to the fact that it was sustained economically by the various forms that credit institutions have taken over time.

Also, unless sudden and drastic reversals occur in the socio-economic system, the enterprise governance - in its various forms and manifestations - if they want to see their projects funded, should take more into account the numerous factors that may make their interests coincide with those of the credit institutions.

Finally, a closer link, almost inseparably, but a link that - given the upheavals brought by the crisis - will make less and less stable the international economic balance, if the banking system does not resume its classic function of credit provider, will mitigate the bias toward exclusive financial speculation or will continue to accommodate making comfortable investments in bonds, undoubtedly profitable and safe, but which in times of crisis consume the vital air of the real economy.

Notes - Part II

- [1] Banca d'Italia, 2011, „Supplementi al Bollettino Statistico. Indagine sulle imprese industriali e dei servizi.”, Roma
- [2] Rangone E.C. (under care), 2011, „Lo spirito dell'economia. La direzione di una grande orchestra”, Pavia University Press, Pavia, p. 798 and following.
- [3] Banca d'Italia, 2011, „Rapporto sulla stabilità finanziaria”, Roma.

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