Corporate Financing in Malta

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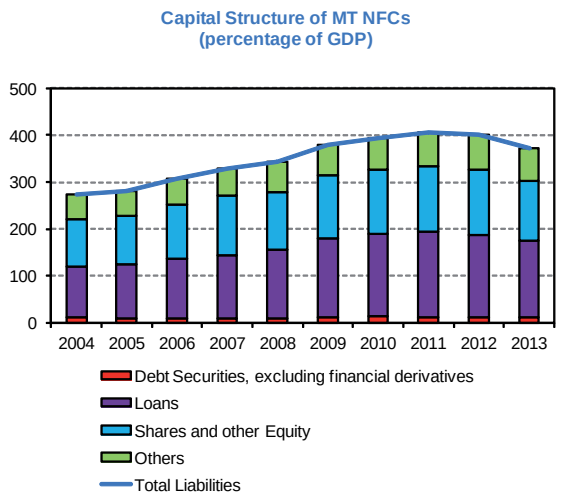
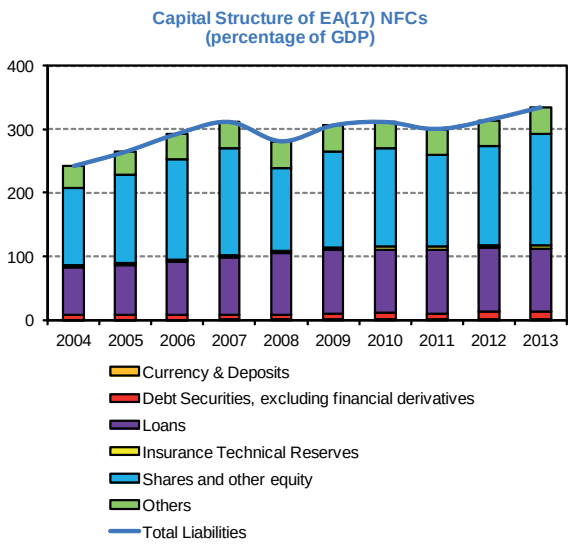
Non-Financial Corporations (NFCs) generate around 58.7 per cent of the total Gross Value Added of the economy. The magnitude and composition of corporate financing may be detrimental to the competitiveness of the NFCs, and can have repercussions on the performance and financial stability of the wider economy. The importance of corporate financing in Malta has been recognised at an EU level and the 2014 Country Specific Recommendations propose to *"encourage alternatives to debt-financing of companies through facilitating access to capital markets and developing venture capital funds"*.

Whilst in the EA(17) equities represent the main source of corporate financing, the capital structure of NFCs in Malta is predominantly composed of debt (Figure 1). As a result, Maltese firms are more leveraged than the rest of their peers in the EA **(Figure 2)**. In the run-up of the international crisis, NFC debt in Malta increased from around 120 per cent of GDP in 2004 to above 140 per cent in 2008 (non-consolidated data), in line with the performance of the EA. In 2009 when the recession hit most economies, debt to GDP increased more strongly in Malta than the EA thus acting as a stronger cushion to NFCs.

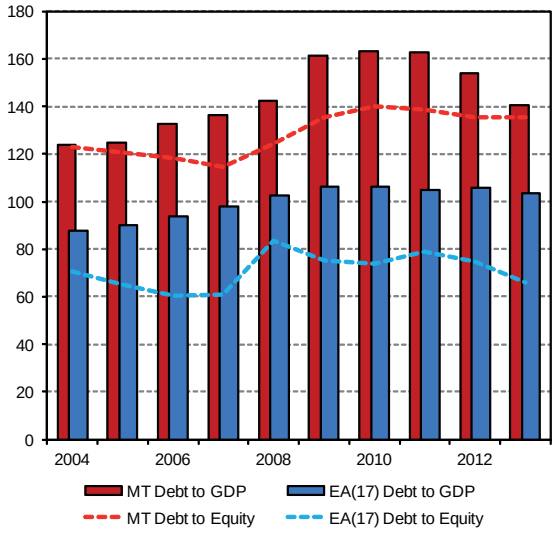
Figure1: Capital Structure of Non-Financial Corporations in Malta and the Euro Area(17).





Source: European Central Bank and European Commission (ECB & EC)

Figure 2: NFC Indebtedness



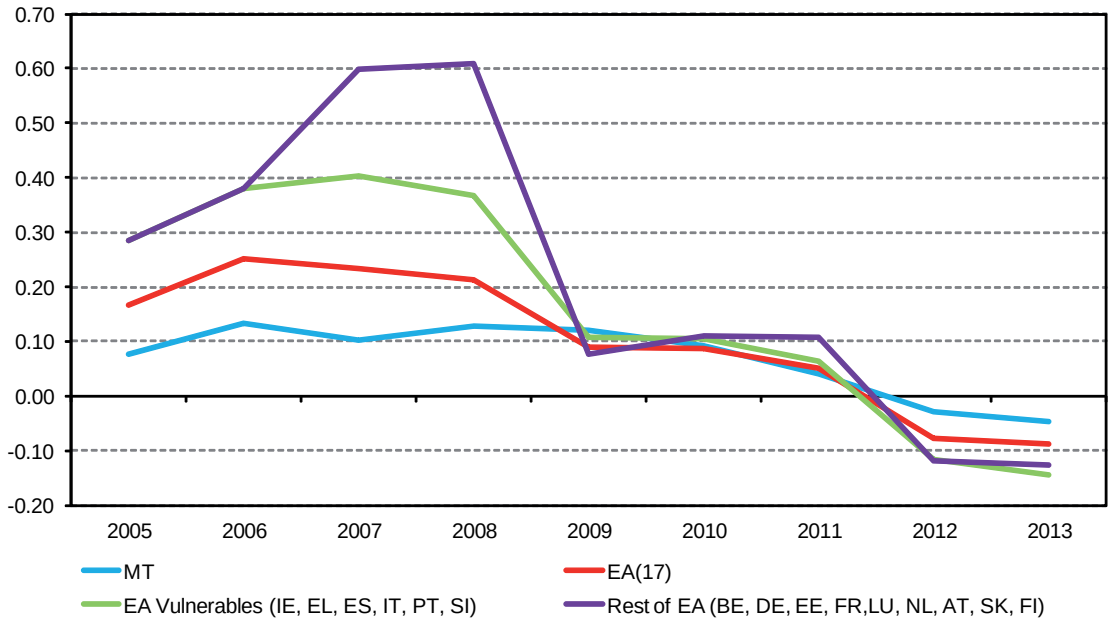
Source: European Central Bank and European Commission (ECB & EC)

The ratio stabilised until 2011 and declined since 2012 as the economy recovered. This indicates that the recent rise in indebtedness was partly cyclical.

The flow of bank lending to the corporate sector fell in 2012 **(Figure 3)** as the economy recovered, with the **decline being more pronounced in the manufacturing and the construction sector (Figure 4)**. As a result, the debt-to-GDP ratio decreased back to 140 per cent by the end of 2013, in line with pre-crisis ratio but remains well above the EA(17) average of around 100 per cent of GDP (non-consolidated data). **This suggests that bank lending in Malta has acted as an important buffer to the severe external shocks and has been an important source of stability in the Maltese economy during the international crisis**.

Beyond the debt-to-GDP ratio, the debt-to-equity ratio is also high, at above 135 per cent in 2013 compared with around 65 per cent in the EA **(Figure 2)** suggesting that NFCs in Malta are more leveraged than their EA counterparts. Furthermore, despite the cyclical drop in debt-to-GDP, NFC leverage has not declined sufficiently in recent years as equity financing also declined. Moreover, the debt-to-asset ratio of Maltese NFCs has actually risen.

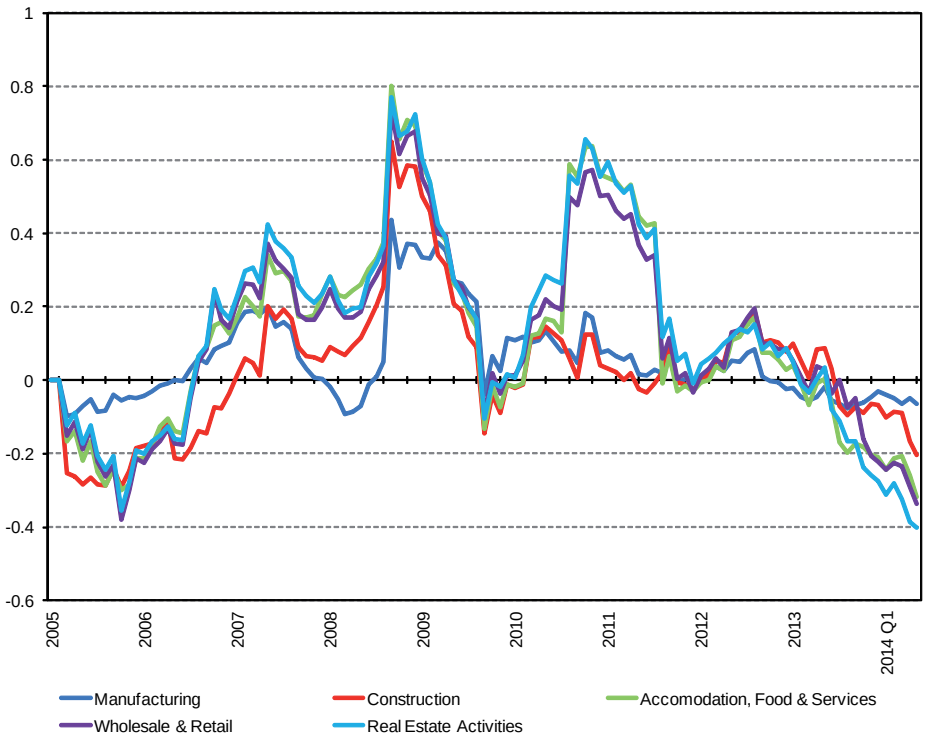
Figure 3: Growth in Bank Lending



*Data for IE and CY was incomplete/unavailable.

Source: European Central Bank and European Commission (ECB & EC)

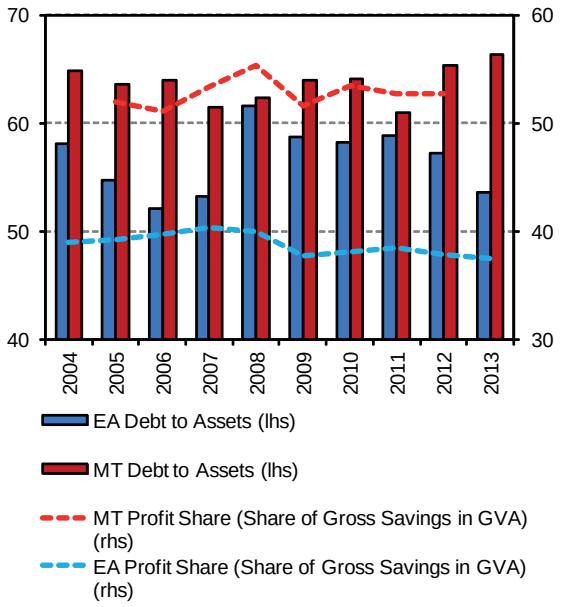
Figure 4: Sectoral Credit Growth



Source: Central Bank of Malta (CBM)

Interestingly however, the share of Gross Operating Surplus in GVA is higher for NFC in Malta than in the EA, suggesting that the higher leverage is partly supported by strong economic fundamentals (Figure 5).

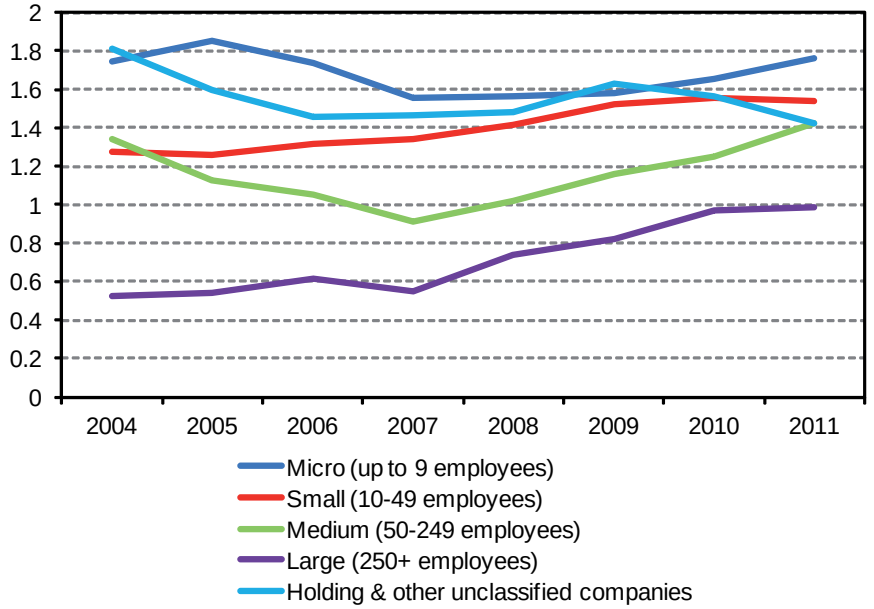
Figure 5: Capacity to Repay



Source: European Central Bank and European Commission (ECB & EC)

Moreover, firm-level data on corporate leverage **(Figure 6)** suggest that the **high leverage in NFCs in Malta is primarily concentrated in micro and small enterprises**. In an economy with a higher predominance of SMEs contributing to gross value added, a higher corporate leverage is expected as access to capital markets for such enterprises is often limited. The leverage ratio of larger enterprises remains less than unity despite its increase in the aftermath of the international crisis and consequently does not present a major source of concern. Leverage in medium-sized enterprises is relatively high at close to 1.4 although a cyclical element cannot be excluded at this stage.

Figure 6: Leverage Ratio for NFCs in Malta, by company size



Source: Inland Revenue Department (IRD) and Central Bank of Malta (CBM)

1. Determinants of Corporate Leverage in Malta

In a study evaluating the sources of corporate leverage in Malta, the Ministry for Finance (MFIN) concluded that **corporate leverage in Malta is around 10 times more heavily influenced by SME intensity compared to the rest of the EU**. In an economy where corporate leverage is inversely related to the size of the company, where the proportion of micro enterprises in Malta (94.1 per cent) is higher than the EU average (92.1 per cent), and where SMEs contribute around 14 per cent more than their EU counterparts to GVA, a higher leverage ratio seems thus a structural characteristic of the economy. Survey evidence reveals that small enterprises are less likely to access equity finance mainly due to perceived lack of relevance to the firm and/or unwillingness to dilute ownership.

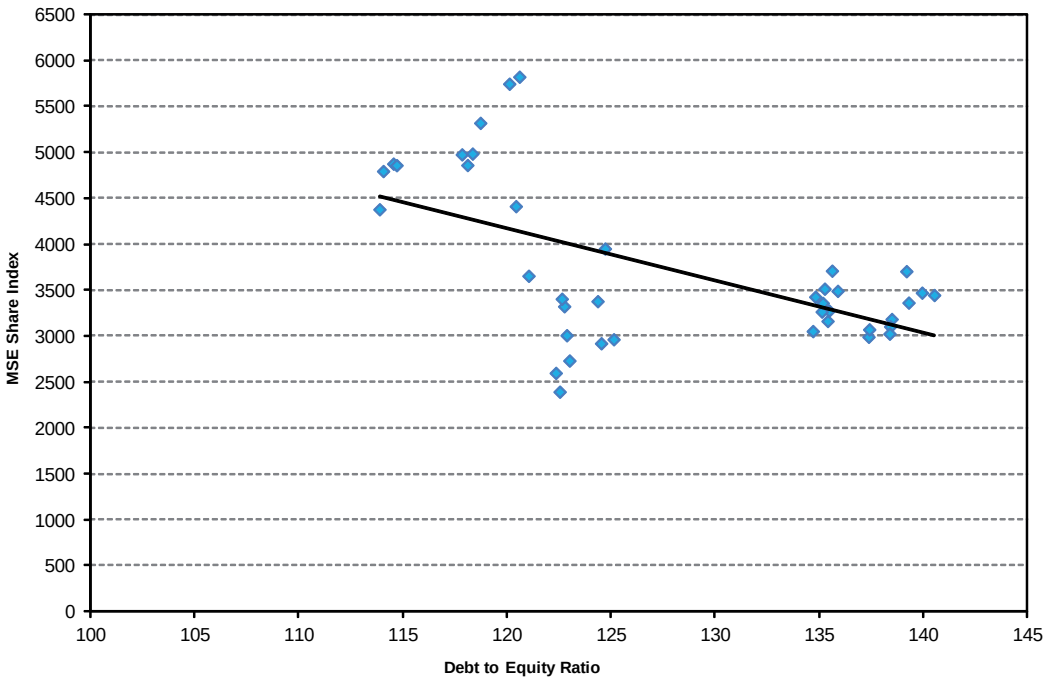
The MFIN study finds that the **development of financial markets in Malta is likely to lower corporate leverage over time**.

Results further suggest that the **capital intensity of production in Malta tends to play a larger role in determining corporate leverage** than in continental Europe suggesting that the servisification of the Maltese economy is also likely to lower corporate leverage over time.

The **openness** of the Maltese economy, which is largely an ingrained characteristic of the Maltese economy, also contribute to lower corporate leverage, possibly indicating that **export oriented companies in Malta are less reliant on debt finance**.

Although the MFIN analysis does not find robust statistical results supporting the **counter-cyclical nature of corporate leverage** in Malta, the inverse correlation between the Malta Stock Exchange index and the debt-to-equity ratio strongly supports the hypothesis of counter cyclicality **(Figure 7)**, with periods of stock market appreciation corresponding with periods of lower corporate leverage.

Figure 7: Corporate Leverage and the Stock Market in Malta (Quarterly Averages for 2004-2013)



Source: European Central Bank, European Commission and Malta Stock Exchange (ECB & EC & MSE)

2. Policy Observations

From a policy perspective, these results suggest that measures aimed at facilitating the link between potential investors and small enterprises; facilitating the **listing of medium sized company**, as well as **industrial policies aimed at encouraging SMEs to grow and incentives to facilitate the entry into international export markets**, have the potential of reducing corporate leverage in the Maltese economy. The **servisification** of the Maltese economy also has the potential of automatically reducing corporate leverage in the Maltese economy. There is also some (albeit inconclusive) evidence that as the stock market recovers, corporate leverage will adjust downwards indicating an **automatic counter-cyclical response**.

Endnote:

*The views expressed in this research article are those of the authors and do not necessarily reflect those of the Economic Policy Department, Ministry for Finance.