Study on Enterprise Financing

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Abstract

The capital structure theory is a very important question in economy, the modern capital structure theory by Modigliani and Miller is proposed based on the assumption of perfect capital market. The core problem of capital structure is the company financing options, with the vigorous development of the world capital markets, enterprise's financing way has become increasingly flexible and diversified, the enterprise should choose different financing ways according to their own situation, give full consideration to the development, production scale, repayment ability and financing risks. This paper briefly introduces the types of enterprise financing, analyses the Chinese enterprises' financing condition, puts forward some suggestions on the selection of corporate financing patterns.

Keywords: Enterprises, financing, capital structure

1. *Enterprises' Financing Way*

Financing way embodies the nature of capital, it is helpful for the enterprise to choose the suitable financing ways through understanding different financing ways and its' attributes. At present, Chinese enterprises' financing ways mainly include: issuance of shares (ordinary shares), bank loans, issuance of corporate bonds, leases, use of retained earnings, and use of commercial credit, direct absorb investment. Here is a brief introduction of several main financing ways.

1.1 Issuance of shares (ordinary shares).

Stock refers to a negotiable certificate held by the company, which is one of the major long-term financing instruments in the capital markets. Ordinary shares has no fixed interest burden and maturity, funds raised by ordinary shares are permanent unless the liquidation of the company. However, the cost of capital is generally higher than other securities. By this way, it will increase new shareholders, that may be decentralize control of the company and weaken the original shareholders' control of the company. As the company listed, it need to perform strict information disclosure system, accept the supervision of the public shareholders, bear substantial information disclosure cost, increase the difficulty of protect business secrets. In addition, business conditions will receive extensive attention of the public after the stock listed, once a company has operational problems, it may face the risk of being acquired.

1.2 Bank loans.

Bank loan is a kind of financing way that enterprises borrow funds needed according to the loan contract from the bank or non bank financial institutions. Bank loan can quickly obtain funds, companies and financial institutions can directly contact with each other, they can determine the borrowing time, the number of loans, interest, payment methods through direct negotiations. during the period of loan, if the enterprise's situation has changed, we also can negotiate with financial institutions to modify the loan contract. After borrowing maturity, if there is any justifiable reason, we also can delay repayment.

But the financial risk of the bank loan is large, the enterprise must debt-service payments on a regular basis, in the case of mismanagement, it may produce not solvency risk and even lead to bankruptcy. In addition, the bank loan has many limits, loan contracts signed by enterprises and financial institutions have a lot of limited provisions that may limit the business activities

1.3 Issuance of corporate bonds.

Issuance of corporate bonds can raise a large amount of funds, it belongs to the direct financing and the issuing object distributed widely, the market capacity is relatively large. Bond investors generally cannot obtain the principal before maturity, so it has the characteristic of long-term and stabilization. It is also helpful to play the role of financial leverage. But the bond issuance procedures are complex, which need to recruit sponsors, accountants, lawyers, asset appraisal institutions and credit rating agencies. It also requires disclose periodic reports and interim reports after the bonds are listed, so the disclosure cost is high. In addition, restrictions to issue corporate bonds generally very stringent, which may affect the normal development of enterprises and their future financing ability?

1.4 Lease.

Lease refers to a contract that the lessor give the lessee exclusive right to use assets. Financing by this way can get money fast and flexible, meanwhile, it has less restrictions. However, the cost of capital is high and the right to dispose assets is limited.

1.5 Use of retained earnings

Retained earnings are formed by the company's after-tax profit, which belongs to equity capital. the cost of capital is low and can keep control of the enterprise, enhance corporate credibility. But the amount of retained earnings is limited and we may face a lot of restrictions if we want to use it.

1.6 Use of commercial credit

Commercial credit is a lending relationship in commodity trading for late payment or advance payment formed between enterprises. On the one hand, commercial credit financing is easy to obtain, for most companies, commercial credit is a continuous form of credit and without the formal financing procedures. On the other hand, the cost of commercial credit is low, if there is no cash discount or use non-interest bearing notes, commercial credit financing has no cost. The biggest drawback of commercial credit financing is that we can only use the money for a short period of time.

1.7 Direct absorb investment.

Direct absorb investment is a way of the enterprise to absorb funds in accordance with the "joint investment, joint management, risk sharing, profit sharing" principle. Direct investment can form a production capacity as soon as possible, with respect to the debt capital, direct investment can be paid to investors according to the business situation and greatly reducing the financial risk. at the same time, absorbing direct investment can improve the credit and loan ability of a company. But the cost of capital is high, when a company operating in good condition, you need to pay more compensation to investors. in addition, it is easy to disperse enterprises' control. if outside investors invest more, they will have a considerable power and even control the enterprises completly. what's worse, it is also very difficult to absorb a large number of social capital to participate in, so the scale is small.

2. Analysis of Chinese Enterprises' Financing Condition

If an enterprise wants to survive and develop, it may in need of capital support, at present, many enterprises exist financial problems, such as funds dispersed, financial information sharing degree is not high, weak supervision and capital utilization efficiency is low, financial cost high and other issues. Summarized from the aspects of financing strategy choice, the main problems exist in Chinese enterprises are as follows.

2.1 Internal financing ratio is low.

The structure of the internal financing for net profit + depreciation and amortization - dividend, external financing includes both debt financing and equity financing. From Table1, the proportion of Chinese listed companies' internal financing is low, the average is only 17.36%, far below the 82.64% of external financing.

Table 1: Capital Structure of Chinese Listed Companies

Particular year	The proportion of Internal financing	The proportion of external financing	
		the proportion of Equity financing	the proportion of Debt financing
2005	17.12	43.13	39.15
2006	16.53	44.40	39.07
2007	13.83	56.62	29.55
2008	13.69	55.11	31.20
2009	18.21	55.90	25.89
2010	18.89	56.10	25.01
2011	20.10	54.18	25.72
2012	20.58	53.98	24.44
The mean	17.36	51.93	30.71

Note: The above data come from the China Futures Statistical Yearbook, China's national monetary policy implementation report.

The main reason is that the profitability of listed companies is not high, which restrict the development of internal financing. affected by the global financial crisis in 2008, the profitability of Chinese listed companies have declined compared to previous years. The overall poor performance of listed companies and lack of cash flow bring many problems, such as internal funds are not sufficient and cannot be the source of financing, companies have no other way but invest in profitable projects through external funding.

2.2 **The proportion of equity financing in external financing is too large**.

From Table1, the equity financing proportion of listed companies is 51.93%, far higher than 30.71% of the debt financing proportion; this fully shows that our listed enterprises mainly rely on equity financing.

The main reason lies in the unbalanced development of capital market. In foreign mature capital market, the bond market financing scale is usually several times the scale of financing in stock market, the amount of corporate bond financing is 3-10 times the amount of its equity financing .However, the structural imbalance of Chinese financial markets, the issue of current examination and approval system, enterprise credit rating system is not sound, as well as corporate bond collateral channels blocked ,all these factors have hindered the development of Chinese corporate bond market. the national credit occupy the dominant position in the bond market, the true sense of the corporate bond market has not yet formed, making this one of the most important financing way in western countries still infancy in today's China .Therefore, the listed company can only choose the equity financing ways.

2.3 Debt financing mainly rely on bank loans, lacks of corporate bond issuance.

Bond financing with large-scale, flexible term advantages, bank loan deficiencies in size and duration, so in developed countries, bond financing is one of the main sources of debt financing, the size of the U.S. corporate bond financing has exceeded the bank loans. But the Chinese listed companies' debt funds mainly come from banks and other financial institutions, rarely involve in bond financing, this point can be seen from table 2.

Table 2 Statistics of Chinese listed companies' debt financing

Particular year	The proportion of bond financing	The proportion of loan financing
2008	14.44%	86.56%
2009	13.13%	86.87%
2010	15.75%	84.25%
2011	14.86%	85.14%
2012	16.18%	83.82%

Note: The above data come from the China Futures Statistical Yearbook, China's national monetary policy implementation report.

3. Selection of Chinese Enterprises' Financing Strategy

3.1 Follow the pecking order theory.

At present, Chinese enterprises' financing order is: equity financing→debt financing → internal financing, this conflicts with the requirement of the pecking order theory, the following table 3 shows why should we follow this theory.

Table 3: pecking order theory

	The current share price	Management expect	Equity pricing results	The results of issue new stock
The first case	50 RMB	60 RMB	The stock is undervalued	New investors only pay 50 RMB to get a 60 RMB worth of stock
The second case	50 RMB	40 RMB	The stock is overvalued	New investors pay 50 RMB but reap only 40 RMB worth of stock

In the case of companies having good prospects and the stock is undervalued, the new investment will get excess returns, while existing shareholders will suffer losses ,On the contrary, in the case of the stock is undervalued and business outlook is poor, which can maintain existing shareholders' value, but will harm the interests of the new shareholders. As a result, investors will worry about the company's value is overvalued when it issue stocks or bonds. Therefore, enterprises will prefer financing from retained earnings as far as possible in order to raise external funding fairly. If the retained earnings cannot meet the needs of the project, enterprises will always give priority to debt financing between external debt financing and equity financing, this is because investors consider the possibility of stocks overvalued far greater than bonds. therefore, in the process of raising capital, enterprises should follow the basic sequence, first consider the internal financing, and then external financing, when we need external financing, we should be in accordance with the different risk degree, give priority to debt financing, then consider equity financing when funds are insufficient.

3.2 Select the appropriate financing strategy based on the life cycle of enterprises.

3.2.1 Start-up period.

During this period, companies need a lot of money for product development and market development, however, the ability to raise capital tends to be poor, which will hinder the survival and development of enterprises, in addition, companies face enormous barriers to entry and competitive pressures at this time, as the new enterprises with no business records or mortgage assets, the credit has not been established, so it is difficult for enterprises to obtain loans from banks. At this stage, companies can use the following financing strategies. First, friends and family, many start-up companies win the first round of investment from friends and family there, this is a good channel; and the second, the entrepreneurial team and internal staff, through internal employee shareholding to get funds can raise the money on one hand, on the other hand can form benefit-sharing, risk-sharing mechanism; the third, actively apply for the national support funds, such as the science and technology innovation fund for small and medium enterprises, innovation service center (incubator); last but not least, we can also seek venture capital investment.

3.2.2 Growth period.

During this period, corporate image and product brand already have a certain popularity and good reputation in the community, investors are relatively optimistic about the prospects, companies can borrow money by issue notes or conduct the supply chain financing, which will not only be able to take advantage of debt financing, but also can introduce the credit of the core company to the small and medium-sized enterprises, so that, the SMEs' credit level will greatly improved and that will help them solve the problem of funds shortage.

3.2.3 Mature period.

During this period, companies have sustained and stable cash flow, huge surplus production capacity, high sales, stable profit space, fixed product market, a growing number of mortgage assets. At this point, the operating risk of the enterprise is very low, so that they can take advantage of the strengths mentioned above and choose high financial risk ways to make sufficient use of debt financing.

3.3 Enterprises should consider the macroeconomic policy changes and select the appropriate mode of financing according to the operating and financial conditions of their own.

3.3.1 Determine the scale of financing, optimizing capital structure, reduce the cost of capital.

An excellent enterprise should have the ability to adjust equity financing proportion and debt financing proportion, make full use of financial leverage to reduce financing costs and increase shareholder value. Due to the different financing methods have different capital costs, in order to lower financing costs and obtain the required funds, companies should analyze and compare various financing capital costs, try to choose those low-cost financing portfolio.

Under normal circumstances, if fixed assets in higher proportion of total assets, total asset turnover is slow, that will require more long-term funds such as equity capital; as for those companies whose current assets account for a large proportion of total assets, their cash flow is fast and they can rely more on current liabilities to raise funds. In order to maintain a good capital structure, those enterprises with high liabilities should reduce the debt ratio and switch to equity financing; when those enterprises with low debt ratio meet the opportunities for investment, moderately increase debt can get financial leverage gains and improve the capital structure.

3.3.2 Actively explore diversified financing methods.

Enterprises should realize the diversification of financing according to the principle of finance income is greater than the cost of financing. Such as convertible bonds and warrants, etc, to break the single equity financing and actively open up financing channels, use diversified financing portfolio in the financing process, reduce costs, avoid risks, and maintain stable development of enterprises.

3.3.3 Increase issue price of the share.

Raise the price of the stock aims at reducing the cost of equity financing and improving the efficiency of it. On the one hand, we should improve operational efficiency in order to improve investors' satisfaction to enterprises; On the other hand, remember choose a good time to issue shares, don't issue too many in the stock market downturn.

3.3.4 Consider the profitability and prospects of enterprises.

Overall, companies with stronger profitability, better financial condition, stronger liquidity, and good growth prospects have greater ability to take financial risks. In the case of corporate debt capital investment profit margin is greater than the interest rate, the more debt it owns, the higher yields on the net assets, which is more beneficial to the enterprise development and the equity capital owners. Therefore, when the profitability of the enterprise is in a period of rising, debt financing is a good choice. When the enterprise is in a poor operating conditions, minimize the use of debt financing to avoid the financial risk is a good choice. Of course, companies with strong profitability and capital expansion capability can raise funds by the way of equity financing or a combination of equity and debt financing if the conditions permitted.

3.3.5 Consider changes in interest rates and tax rates.

If the current interest rate is low, but to predict it is likely to rise in future, in this case, companies can raise funds by issuing long-term bonds, so the interest rate is fixed for several years on the lower level. Conversely, if the current interest rate is high, companies can use the way of equity financing or current liabilities to raise funds in order to avoid financial risks. Take tax rate for example, companies can get a tax advantage of debt capital interests, so the higher the tax rate, the more tax revenue obtained through debt financing. In this condition, companies can give priority to debt financing. Conversely, companies with low tax rate can obtain less tax revenue through debt financing, so they may consider equity financing.

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