Corporate Capital Structure Determinants of Companies in China and Possible Optimization Countermeasures

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Abstract

Capital structure reflect the value composition and proportion relationship of corporate capital, the proportion of debt and equity. It is an important indicator for measuring enterprises’ solvency and financing capacity. It determines the profitability to a certain extent, which is also a reference index for investors to make investment decision. Therefore, except paying attention to external market environment during operation, analyzing, adjusting, and optimizing the existing capital structure constantly is an important topic for enterprises as well. A reasonable capital structure could ensure the effective allocation of firms’ resources and keep consistent with its development strategic objectives. This paper takes the theory of capital structure as the basis, combines with the actual situation of the enterprises capital structure in China to analyze current structures’ characteristics, determinants and potential problems, then puts forward the proposal of optimization.

Keywords

Capital Structure; Enterprises; Capital Structure Optimization; China.

1. Introduction

1.1. Research background

The theory of corporate capital structure plays an important role in corporate finance theory. The classic ‘MM’ theory is an effective reference for the academic study if capital structure, it also lays a solid foundation for modern financial research. Nonetheless, a huge gap still exists between the theory and practical application.

1.2. Current situation in China

Since the reform and opening up, the society economy in China experienced rapid development, enterprises with comprehensive strength and core competitiveness emerged constantly. However, compared to the matured system of world capital market, certain differences still exist. The research on relevant issues is also in the rising and developing stage, hence the standard theory cannot be fully referenced, the specific analysis should be carried out in the combination with the actual national conditions, policies and restrictions.

2. Determinants of capital structure

2.1. External factors

2.1.1. Economic cycle

Most of enterprises would experience a series of cycles since the establishment to demise, which could be roughly defined as two separated stages: economic boom and recession stage. [1,3] Actually, the companies in different stages own specific development features and demands. For instance, the capital level and market share of a firm in boom period usually performs optimistically. Also, the products are in short supply at the moment, therefore the
senior management probably has a relatively ideal expectations for future market. In this situation, enterprises could enhance their own strength and expand the operation scale by increasing the debt proportion. In contrast, during recession stage, the product market is basically in the state of oversupply. If an enterprise keeps increasing its debt weight, this is likely to bring adverse results. In other words, the firm’s capital structure adjustment should match with the actual economic cycle, or it will not only fail to achieve the optimization objective, but also sustain further deterioration of capital structure. Thus, it can be seen that economic cycle is one of important macro-influencing factors in capital structure.

2.1.2. Taxation mechanism

Tax payment is an essential responsibility for firms, it also takes an relative large proportion in their expenditure. According to existing tax policies in China, the interest incurred from liabilities should be classified as enterprise cost, this stipulation causes a significant impact on capital structure. To be specific, although Chinese government has invited some new tax regulations and a series of preferential policies in order to reducing the corporate tax burden for those firms, the tax cost is still a huge source of enterprises’ financial pressure. [2] Under this circumstance, some firms would increase financing to ease the pressure and maintain development objectives at the same time. However, in the case of insufficient financing situation, debt financing becomes the first best choice, which would inevitably generate corresponding interest expenditure. At the end, the profit level would be deducted. Thus, tax mechanism is also an incentive that promotes enterprise to optimize capital structure, but it also requires relative tax policies from the government to stabilize the economic market.

2.1.3. Market competition

Companies in different industries would face different levels of competition and degrees of market usage. The capital structure optimization and adjustment is an action that has great and long-term influence on their own development, the relevant information of market competition needs to be taken into consideration. This is because the market situation is inherently changeable, companies could only make predictions based on their own information and previous experiences. When the market competition is extreme fierce, a huge deviation would probably exists in firms’ prediction, and this will lead the firms to be exposed to greater operational risks. Therefore, unexpected events are likely to occur during the structure optimization process. In contrast, if the market environment is relatively mild, the firms’ operation would be easier. What’s more, on the basis of analyzing the actual situation, firms could reasonably increase the leverage ratio, which would also accelerate the optimizing progression.

3. Internal factors

3.1. Enterprise operation condition

In addition to external factors, there are also some internal factors which affecting capital structure optimization, such as operational risk. For enterprises, operational risks are inevitable. Risks exist as long as there is business development and capital operation, and the only difference is its size and whether it is manageable. For example, when there is a high leverage ratio in the firm, the investors are unlikely to invest in this firm due to the uncontrollable risks, and this causes the financing difficulty. Eventually, the stability of enterprise’s operating conditions will be affected directly. However, in the case with low risk level, the enterprise would own stronger support in formulating optimization plans and enough capacity to work against unexpected risks.
4. Countermeasures of optimizing enterprises’ capital structure in China

4.1. Externally

4.1.1. Strengthen bond market development

Nowadays, there are still some existing problems in the bond market of China: the issuance market and trading market are not unified, the system of bond market is not enough perfect to be geared to international standards; although the scale of bond issuance continues expanding in recent years, it still lags far behind the stock size; low market liquidity and interest rates on corporate bonds, inadequate market regulation. [3] The financing sources of enterprises in China are restricted and limited due to the serious imbalance between the development of bond market and stock market, which also restrains the capital structure optimization. Here are some suggestions on developing the bond market: firstly, issuing corporate bonds, optimizing bond market structure; secondly, establishing complete bond market operation mechanism, relaxing bond interest rate restrictions, promoting the liberalization of interest rate, and enhancing the market liquidity; thirdly, improving current regulations, strengthening market supervision, and carrying out appropriate macro-control to ensure the health of bond market; finally, applying a series of measures to encourage firms to raise funds through bond market to improve current capital structures.

4.1.2. Improving market economic environment system

The quality of market environment is related to the sustainability and health of the enterprises which operated under the market guidance. [4] In China, some obvious drawbacks, such as blindness, hysteresis still exists, therefore, optimizing market environment is the primary task now. Also, the government should try to guide the firms by using indirect macro-control methods, for instance, tax policies reformation, interest rates adjustment and so on.

4.2. Internally

4.2.1. Enhancing profitability

Enterprises should spend more profits on its own funds accumulation, which makes its own capital more sufficient to achieve the optimization purpose. Also, endogenous financing is a favorable guarantee for exogenous financing.

4.2.2. Optimizing ownership structure

Highly concentrated ownership structure could be optimized through several ways: first, introducing new investment subjects to improve diversification and reduce equity concentration degree; second, increasing managers’ shareholding ratio to achieve the consistency between managers’ benefit and enterprises’ value maximization, and promote the formation of long-term incentive mechanism to improve managers’ enthusiasm; third, establishing efficient supervision mechanism.

5. Conclusion

The capital structure optimization could enhance firms’ value and attract investment. Factors like economic cycle, market competition, tax mechanism would affect the structure. However, we could reduce the risks by adjusting debt structure and diversifying the financing sources. Based on current development situation in China, it is necessary to apply further capital structure optimization policies. In the process of designing those policies and plans, the enterprises should find out a scientific method to maximize its own interests.
References


