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Study on the financing methods of China's listed companies

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Abstract. This paper takes enterprise's financing decisions as research object. By analyzing the current situation of the use of financial leverage in China, we find that the distribution of financial leverage is extremely uneven, with the proportion of equity financing in China's listed companies far more than debt financing. In order to optimize financing methods of listed companies in China, we should vigorously develop the bond market, promote debt financing, make a reform on share division and banking marketization, and promote corporate bond financing.

Keywords: financing method, financial leverage, equity financing, debt financing

1. Introduction

In the 30 years of Reform and Opening up, our enterprises have experienced a reform process from planned economy to market economy. In the unceasing changes, as the expanse of organization scale and increase of market competition, many listed companies are faced up with financial crisis because of inappropriate arrangements about capital structure, financing decisions and other major financial issues. Upheaval of enterprises' management environment and expansion of financial management activity areas cause investment decisions to be more and more important to the survival and development of enterprises, so to strengthen the study in enterprises' financing options as one of the most important rings in the choices influencing the capital structure of enterprises is of great significance.

Currently, existing research results from home and abroad concerning the relationship between corporate governance and financing modes show that the choice of financing modes makes a decisive role in corporate governance. Carl. M. Sandberg (1987) suggested that lever decision was the key point of the combination of finance and enterprise's financing decision [1]. In the study, Li Weian pointed that enterprise's capital structure reflected the power base of corporate governance subject, reasonable capital structure can decide the performance of the enterprise's management and effectiveness of company's governance to a extent [2]. In this paper, on the basis of the advanced capital theory and financing strategies from home and abroad, we select financial leverage this risk control tool as the main way of financing decisions in China's listed companies and put forward the issuance of corporate bonds as an important means of financial leverage's use through the comparison of domestic and foreign fund-raising means.

2. Theory basis

Business financing method is the specific form of enterprise raising funds. In this paper, we divide it into three categories according to different criteria: internal source of financing and external source of financing, direct financing and indirect financing, and equity financing and debt financing. Internal source of financing is the funds generated from company's operating activities, namely transforming their own savings (including retained earnings, depreciation and fixed liabilities) into investment. With features of being original, autonomous, low cost and risk resistant for capital formation of enterprises, it is essential for the

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survival and development of an enterprise. External source of financing is enterprises raising money from some other economic entities.

There are many influencing factors on financing decisions. From a large perspective, there are national factors, macroeconomic factors, industry factors and firm characteristics factors. This paper focuses on the firm characteristics factors and its relationship with the financial leverage. On the whole, firm characteristic factors include asset composition and uniqueness.

(1)Asset composition: capital structure theory argues that the security of tangible assets can reduce the agency costs of debt to a certain extent. In terms of pecking order theory, companies with fewer intangible assets are more sensitive to information asymmetry, and when in need of external financing, these companies will issue debt rather than equity. Therefore, tangible assets and leverage are positively related.

(2)Uniqueness: According to stakeholder theory, in companies producing unique products, customers, suppliers and workers suffer from higher costs, and customer service replacements are more difficult to find. in line with agency costs, the search for employees who do popular work are expected to cost less than the search for that who implement dedicated work. Therefore, when other conditions are equal, the agency costs related to humans are higher for the companies providing specialized products and services. Uniqueness should be negatively related with leverage.

3. Analysis of current status of financing options in China's listed companies

In this paper, we analyse the current situation of China's listed companies' financing choices from the perspective of internal source financing and external source financing, direct financing and indirect financing, and equity financing and debt financing respectively.

(1) Internal source financing and external source financing. In the financing structure of China's listed companies, the internal source financing's proportion is relatively low. For the listed companies with positive undistributed profits, the proportions of external source financing are usually between 80-90%, much higher than the internal source financing. While those listed companies with negative retained earnings are almost entirely dependent on external financing, the proportions are almost above 90%. After 1998, such listed companies' internal source financing's ratio are more than -10%, totally dependent on external financing. On the whole, China's listed companies heavily rely on external financing.

(2) Direct financing and Indirect financing. The asset-debt ratios of our country’s listed companies are below the national average level, taking on a declining trend over the years. This is resulted from the long-standing single financial system, which leads to over-indebtedness of state-owned enterprises. After reorganizing share system and receiving market approval, the state owned enterprise can get a lot of capital by the direct financing activities, such as issuing new shares and follow-up distributing shares, thus reducing the asset-liability ratio. The ratio of assets and liabilities of China’s listed companies being low reflects the fact that a large number debt of listed companies are stripped off.

(3) Equity financing and Debt financing. Equity financing and debt financing are two basic modes of financing in external financing. In a mature stock market, the proportion of bond market is much larger than the stock market, roughly 20-30% for the stock market, 70-80% for bond market. While in our country, the situation of equity financing and debt financing in listed companies is completely on the contrary. Our country's listed company's external funding sources have shown a typical feature of "light debt financing, heavy equity financing", reflecting the obvious preference for equity financing and forming a serious "misappropriating syndrome", which is obviously conflict with the pecking order theory of modern finance structure theory. In a mature capital market, listed companies are very cautious on the use of equity financing, because issuing equity to raise fund is generally considered as the information of poor prospect of the company. In the U.S, listed companies make one allotment every 18.5 years on average. Since 1960s, the cancellation and buyback of shares of listed companies excess the total number of shares issued, and net increase in stock offerings appeared negative. Issuing stock to finance has become a taboo for listed companies in the U.S. However, in our country, the situation is opposite. In recent years, China's listed companies undoubtedly prefer equity financing, while showing a strong preference in the allotment and issuance of new shares on the choice of re-financing.

4. Analysis on current usage of financial leverage of listed companies in China

There are two main sources of funding in enterprises: equity financing and debt financing. Financial leverage, as an indispensable part in the enterprises' decision-making, has a significant impact on the capital structure. By comparative study, it is found that the use of financial leverage in our country's business becomes polarize. The average ratio of debt of state-owned enterprises is over 80%, of which current liabilities ratio is up to 90% or more, far beyond normal debt level. Of course, the high debt of state-owned enterprises is caused by many reasons: the funding of state-owned enterprises in China before 1979 was mainly from national inputs, only few were borrowed funds. In 1979, the infrastructure investment implemented changing allocation of funds into loans system, and in July 1983, ministry of finance no longer allocated liquid funds to enterprises. These two measures make state-owned enterprises' capital structure changing significantly: bank's debts soared; business's assets and liabilities increased dramatically, showing no tendency of going down. In 1993, the state-owned enterprise financial system reform made a breakthrough, allowing enterprises to raise funds in multi-mode and multi-channel, and began to gradually carry out share system reform in state-owned enterprises. However, because our financial system's reform falls far behind and capital market development is incomplete, the only source of enterprises' external source financing is bank loans. The corresponding four state-owned commercial banks' ratio of bad loan reached 30%, far exceeding 17%, the Central Bank's set ratio. Compared to the asset-liability ratio of 86.5% in the state-owned enterprises, the asset-liability ratio of less than 50% in listed companies was low. Li Lei (2009) made an analysis of the use of financial leverage in the non-financial listed companies from Shanghai Stock Market between 2001 and 2007(Table 1) [4].

Table 1 the use of financial leverage in listed companies from 2001 to 2007

Year	Average financial leverage	10%-30%	Less than 50%	More than 50%	More than 70%
2001	0.448	23.1%	80.8%	38.5%	7.3%
2002	0.416	21%	78.8%	39.9%	6.3%
2003	0.450	19.1%	79.1%	48.5%	5.4%
2004	0.501	12.1%	79.1%	43.4%	10.3%
2005	0.519	11.5%	73.3%	28.3%	13.5%
2006	0.516	11.8%	70%	23.6%	14.7%
2007	0.513	12.5%	77.4%	28.8%	13.4%

Data source: Li Lei. Empirical study on listed companies' overall level of financial leverage in China [J]. The contemporary economy, 2009 (02): 90-96.

Table 1 suggests:

(1) The average utilization of financial leverage in China's listed companies increased year by year.

(2) Distribution of financial leverage was very uneven. On the whole, the enterprises at a lower level of 10% - 30% declined. While the ratio in a higher level of more than 70% was not much, though there was a rising trend year by year.

(3) The uncertainty of company's operation increases. If we take a company with a leverage factor less than 50% as a safe state, most of China's listed companies were still in a safe state, But the number of companies in the safe state was in an obvious decline (except for an increase in 2007).

(4) There being the financial leverage effect in a large part of China's listed company is in unreasonable state. For a company whose financial leverage plays a positive role, in the case of its high profitability level, it neglectes to improve the profitability through borrowing funds, thus it doesn't make full use of financial leverage. We can see that the positive effect is small. In listed companies with leverage playing a negative effect, there are also many cases of high level financial leverage. In 7 years, the proportion of enterprises whose financial leverage are more than 50% and highly indebted has decreased, but still large.

5. Policy recommendations on the financing options of listed companies

5.1 Develop debt financing positively

China's listed companies' profitability is not strong, so they have to rely more on external financing, especially equity financing. Equity financing capital changes frequently and lacks supervision, making little or no effect on performance after the company's financing, with half of listed companies' operating conditions were damaged within a few years after fund-raising.

The management of creditors to the operators is most strict. To improve China's listed companies' financing behaviour and optimize the financing structure, we should develop the bond market and promote debt financing, while the latter one can not develop without state's support, thus, I will give a few suggestions from a macro perspective :

(1) Equity division reform. China's shares are divided into state shares, legal person shares, individual shares and foreign shares, and the state-owned shares and legal person shares can not circulate. So the phenomenon of internal control of listed companies take place, encouraging equity financing behaviour of listed companies and distorting the stock market pricing mechanism. Thus, promoting the split share structure reform can fundamentally solve the problem of irrational ownership structure of stock market, clearing the path for optimizing the financing structure in listed companies.

(2) Bank market reform. After the commercial banks' share reform, introducing modern enterprise system into the banking system can reduce government intervention in business activities of banks, thus effectively regulate banking activities and harden debt financing constraints, improving the efficiency of the entire economic system.

(3) Developing corporate bonds. Bonds has a collection of "public creditors" nature, which means if the debt business fail to make the scheduled performance and damage the public creditors' interests, public opinion will be widely involved in and government departments will also intervene in, causing great pressure on the debtors. Therefore, the contract of bond financing has great rigidity, which can cause companies to increase self-discipline, increase economic efficiency and improve corporate governance and corporate finance funds' efficiency. In the context of soft constraints in our banks, vigorously developing corporate bond markets, increasing the proportion of bond financing, and forming a reasonable financing structure, is a rational choice to optimize financial structure of listed companies.

5.2 promoting corporate bond financing

Since mid 1980s, in the western developed countries, bond financing has increasingly replaced the stock financing, becoming a major financing tool with the trend. The tendency of corporate bond financing is more obvious. But China's securities market has always been taking on the feature of "strong stock market, weak bond market, strong bond, weak corporate bonds". Compared to domestic bank credit and equity financing, corporate bonds in China is still a marginal corporate financing method. Corporate bonds, with small size, slow growth and low share in the financing structure, is overshadowed in the national economy. For this, Government and banks must take responsibility and promote the development of corporate bonds:

(1) Government should strengthen the policy orientation. Since the 90s, the Government implemented a proactive fiscal policy. In order to cover budget deficits, the Government vigorously developed the bond market and clearly stipulated that only after the national debt finished issuing can corporate bonds be issued. Government has been taking "attach more attention to stock and less to bond; attach more attention to government loan and less to corporate bond" policy. Government has always been cautious to corporate bonds. Therefore, more restrictions need to be released on corporate bonds to fundamentally improve business financing environment.

(2) Reverse capital market development policies oriented bias. Original intention of the policy to develop securities market bias seriously distorted the cost constraints of state-owned corporate finance concepts, which causes a strong preference of enterprises for equity financing. Many listed companies use funds raised from the stock market to repay bank loans. Even for debt financing, listed companies would prefer to bank loans rather than corporate bond financing. This is because the bank's restrictions are much less, and when state-owned listed companies owe money from the state-owned banks, the punishment is relatively light. Therefore, the government should strengthen punishments for owing bank deposits, reducing the enterprise's "dependency".

(3) Open restrictions on system of corporate bond issuance. Relevant laws and regulations corresponding to corporate bonds issued in our country are "Corporate Bond Management Regulations", "Company Law", "Securities Law", "listed companies to issue convertible bonds Implementation Measures" and so on. China's corporate bond issuance should be approved by the State Economic and Trade Commission (Planning Commission), and then signed by the People's Bank and the Commission and submitted to the State Council for final approval. Layers of restrictions not only lead to the increasing costs of corporate bonds, but also the effectiveness is very poor.

(4) Improve the liquidity of corporate bond. For our country's enterprise bond market's liquidity is small, corporate bonds over the counter has not formed. The risk of corporate bonds can not be released before payment, which is not good for sustained development of corporate bond market. Poor distribution market also directly affected primary market, restricting the development of the whole China's corporate bond market.

(5) Relieve limit of corporate bond issuance level .The upper limit of the interest rate of issuance of corporate bonds over the same period can not exceed 40%, which results in a corporate bond rate consistent pattern. Enterprises with a good reputation and be able to finance at a lower cost are unwilling to issue bonds, while the companies with a poor reputation compete to issue bonds, forming a "bad money drives out good money" effect, making a bad influence in the long-term on the development of corporate bond market.

6. Conclusion

Taking the decision-making of business financing as the research object, this paper analyzes the current situation of the use of financial leverage in China and concludes that listed companies in China rely heavily on equity financing, financial leverage is unbalanced and significantly polarized. Such status quo mainly lies in: high rate of assets and liabilities of state-owned enterprises, the reform of financial system seriously falls behind, capital market development is incomplete. Therefore, in order to optimize the financing of listed companies in China, government should actively develop the bond market, promote debt financing, carry out the share reform and the bank market reform and promote the corporate bond financing.

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