# Choice of Timing of Corporate Debt Financing

Linan Wang[1],Jingrong Li[1]
[1] *Department of Accounting, Jilin University of Finance and Economic, Jingyue Street, Changchun, China*
*{Linan Wangr, Jingrong Li}81212308@qq.com, 1508883250@qq.com*

Keywords: Debt financing ;balance theory ;market timing theory; timing decision.

Abstract: According to the current corporate debt financing inappropriate timing of the situation, through the research on the history of the development of finance theory review, found that listed companies can be trade-off theory and market timing theory combined with the financing decisions on the timing.Capital structure analysis of the trade-off theory as a reference of the major factors and market timing as auxiliary reference factors, more beneficial to accurately determine the timing of debt financing. Break through the past only through a theory to analyze the timing of the financing of the current situation, make the analysis more comprehensive, more convincing.

## 1 INTRODUCTION TO THE THEORY OF TIMING OF CORPORATE DEBT FINANCING

### 1.1 Trade-off theory

The main emphasis of the trade-off theory is that the company does have the most efficient capital structure. It believes that the enterprise can obtain the advantage of reducing the enterprise income tax from the debt, the increase of liability can reduce the average cost of capital. But the company will also increase the cost of bankruptcy and corporate risk because of the increase in liabilities, which makes the average capital cost increased. Therefore, the tax shield effect and the bankruptcy cost make the capital structure of enterprises in the most efficient position, at this time, the average capital cost is in the least position.

### 1.2 Market timing theory

Market timing theory is different from the traditional finance theory.In the past, we start from the financial point of view of financing to fight for the interests of the company, and the market timing theory is from the ever-changing market to choose a favorable opportunity to finance.In short, the theory is not the focus of the company's capital structure and the relationship between the optimal capital structure.

When dealing with debt financing, equity financing problems usually use market timing theory. Such as:

The first example: A company shares of the issued total of $1 billion, total float cost of $30 million. When equity financing is not carried out, the equity value of $750 million. When equity financing, the corresponding adjustment of the net present value of $220 million. Therefore, the company needs to bear the remaining $30 million to make up the $250 million of the original shareholders of the wealth.

The second example:B company value is undervalue by 25 percentage points after, only $1 billion to have the ability to create $1 billion 250 million of wealth, and the corresponding adjustment of the net present value of $250 million. The $250 million flow process for specific performance reduction of $250 million from the exercise of shareholder, and the shareholder equity holdings increased $250 million.

In summary, the company managers to consider the market timing rather than the capital structure of the company's internal for the company's shareholders to earn a huge profit.

According to the influence factors and research methods, the theory of market timing theory is not the same, which is shown as the following indicators: Book ratio of market capitalization, direct and indirect financing costs and the issue of peak season, etc.



Li J. and Wang L.
Choice of Timing of Corporate Debt Financing.
DOI: 10.5220/0006444000740078
In *ISME 2016 - Information Science and Management Engineering IV (ISME 2016)*, pages 74-78
ISBN: 978-989-758-208-0
Copyright © 2016 by SCITEPRESS – Science and Technology Publications, Lda. All rights reserved

Choice of Timing of Corporate Debt Financing

# 2 THEORETICAL ANALYSIS ON THE TIMING OF CORPORATE DEBT FINANCING

## 2.1 Applying the tradeoff theory to analyze the timing of debt financing

The core content of trade-off theory is the company's capital structure to achieve the most perfect statet, in other words, the operation of the company's capital to achieve a balance point, known as the target leverage ratio. The basic content of the theory: first, in the precondition of tax shield protection, in the precondition of tax shield protection, the company's debt level and average capital cost is inversely proportional.The higher the debt, the lower the cost and vice versa,eventually lead to the company's debt financing to seek certain benefits for their own; secondly, the protection status of the tax shield can't be extended indefinitely.because the company itself needs a certain cost to have the ability to repay the debt..In the process of constantly improving the level of debt, agency costs, the cost of the financial crisis, the existence of bankruptcy costs will lead to more and more debt costs, the final tax shield can not meet the high increase of the cost of debt..In summary, the company's capital structure to achieve the most perfect optimal state is also the average cost of the company's average cost of capital. According to the content of the trade-off theory, for the debt financing, the company's managers do everything we can to achieve the theory of the optimal capital structure. With the gradual realization of optimal capital structure, debt and equity financing process will be smoothly done or easily solved.So as to achieve the most perfect ratio, the average cost of the company's capital is the lowest, and the benefits are maximized.Company managers constantly perfect the specific performance of debt and equity issues in the process of corporate structure for the following two points: first, the company structure did not reach the optimal capital structure, considering the debt problem, namely debt financing; second, the company structure is higher than the optimal capital structure, the company from the perspective of equity perspective, namely equity financing. Therefore, when the company choose debt financing, first to determine the relationship between the structure and the optimal capital structure of the company, after the analysis of the conclusion, and then choose the way of debt financing, so as to reap the greatest benefits.

## 2.2 Applying market timing theory to analyze the timing of debt financing

Market timing theory is not only applicable to equity financing, but also applies to certain debt financing. In our country, debt financing from the market point of view, there are three main factors: equity financing substitution, market cost and policy timing(Zhiqiang,2009). Described as the following two conditions: first, equity financing has the advantage conditions, selection of equity financing, debt financing is not considered; second, The low interest rate of the debt financing market and the site policy is conducive to the issuance of securities,choose debt financing.

### 2.2.1 An Analysis of the Substitution of Equity Financing

According to the content mentioned above, the company's financing methods can be summarized as equity financing and debt financing. According to the different financial market and market timing, select different financing methods, and the two can substitute each other. When studying the existing financing methods in our country, we mainly discuss the vicarism of equity financing to debt financing.

Each one has its own merits, two kinds of financing theory, we should choose different financing ways according to the actual situation, so as to find the development for the company's interests. Due to the different cultural regions, in China's financial market, most listed companies in equity financing, ignoring the advantages of debt financing.

By Guixin Han research, the company listed in the previous period of time, usually do our best to improve all kinds of preparations in order to have the ability to conduct large-scale equity financing after the listing(Guixin,2006). Specific performance: the unlisted companies through a short time to enhance their own strength after the issuance of shares of listed companies, successfully listed after preparing the right allotment and issuance of refinancing, so there are "hot issue" and "heat" phenomenon in China's listed companies issue.

So the proportion of equity financing in our country is larger in the way of financing, in general, it will not take credit financing.

### 2.2.2 Analysis of Cost Timing

From the literal point of view, the cost timing is low cost time; researchers will enterprise comprehensive cost of debt financing is low time known as the cost


75

of timing.The cost is composed of the coupon rate, the loan interest rate, transaction costs and other financial costs. When the third party financing and trade relations and to pay a certain sum of money to the third party called the cost of transaction costs, the company itself for the financing and the additional expenses attributed to other financial costs, because these two kinds of cost less affected by changes in the market, so negligible considering the cost of time. So the main influence factors of the cost timing is the face interest rate or the loan interest rate.

The coupon rate or loan interest rate factors including market interest rate level, industry level of risk, the enterprise's own business situation, the 3 Influence Factors and the comprehensive cost of debt financing is proportional to. On the one hand, the lower the level, the better the business situation, the lower the cost; on the contrary, it is the opposite. On the other hand, the impact of the three factors on the comprehensive cost of corporate debt financing is independent of each other, there is no correlation between the two.The effect of the same between the two is not dependent on the relationship between the two .For example, in 2015 China's overall decline in interest rates led to the situation when the economic downturn, coal, steel and other industries with excess production capacity increased risk levels.

Although the majority of Chinese listed companies with equity financing,but the specific ways to carry out financing methods are different .After the data analysis was carried out by using the measurement model of Liu .we draw the following conclusions: the enterprise to reduce the comprehensive cost of debt financing way for debt financing, in order to cope with the market interest rate level is low the situation(Lanbiao,2012).

### 2.2.3 Analysis of the Timing of the Policy

Due to the nature of our country, some of the policies of the government will have a direct impact on economic development, debt financing is also listed in this. Companies in related behavior at the same time according to the current policy to get maximum benefit.

With the most typical corporate bonds: in some developed countries, the debt market has long been and so far has a certain size, and China has just entered the right track. The earliest can be traced back to nine years ago, China has just begun the formal approval of this: "corporate bonds issuance pilot approach".After that, the debt market of our country began to develop slowly.In order to improve the current debt market, at the end of 2014, the government began to collect all walks of life on the debt industry related advice-- "corporate bond issuance and transaction management approach",and after a period of time to achieve effective results -- " corporate bonds issuance and transaction management approach"issueso that is more conducive to the future development of the debt industry.

## 3 THE TRADE-OFF THEORY AND MARKET TIMING THEORY COMBINED

The following mainly through two directions in the process of debt financing in the process of how to grasp the best opportunity, these two directions are trade off theory and market timing theory. According to the trade-off theory, we can know that there is a best of its own capital structure for each company, and not any time to start debt financing.When there is a gap in the best capital structure, debt financing is the best form. When higher than the best structure is not the best model, then the need for equity financing rather than debt financing.

According to the theoretical analysis of the balance of the capital structure of the company's choice of debt financing is the main impact factor,at the same time also need to auxiliary reference market timing factor.

But the importance of market timing is closely related to the target leverage ratio. For every enterprise has an optimal leverage ratio.First of all, when they are away from the leverage ratio, there is a certain gap,they do not consider the market opportunity.,because the market timing of benefit is far lower than that caused by other losses, and for those with the leverage ratio is very small distance between enterprises at this point, consider the market opportunity to bring extra income, because it itself has achieved the goal of leverage, can increase revenue through the consideration of other factors.

Explain the following specific target leverage ratio influence on market timing: the current leverage ratio than the optimal leverage ratio is high, the enterprise will be financially facing a very grim situation, because the loan ratio is relatively large, limited the further development of the enterprise, is the enterprise and lend a party there some of the contradictions; the current leverage ratio is low, although the market timing can bring benefits, but


76

Choice of Timing of Corporate Debt Financing

the income is very small, you can choose other ways to increase revenue.

In short, when the leverage ratio does not reach the optimal leverage, to consider the market timing of the gain is not a wise choice, will bring greater risk and loss. So an enterprise to decide whether to use the market timing, according to the current leverage to make judgments.

# 4 A SUMMARY AND SUGGESTION ON THE TIMING OF CORPORATE DEBT FINANCING

## 4.1 A Summary of the Timing of Corporate Debt Financing

When the enterprise wants to choose the best time in the debt financing, must be clear about the relationship between the leverage ratio and the target leverage, and then consider the market timing.

According to the trade-off theory, we can know that there is a best of its own capital structure for each company, and not any time to start debt financing.When there is a gap in the best capital structure, debt financing is the best form. When higher than the best structure is not the best model, then the need for equity financing rather than debt financing.

Through the above analysis, we know that only when the current leverage leverage target in the vicinity, to choose the appropriate market opportunity to obtain greater returns is very feasible, because this caused the loss of leverage is far lower than the income.

With the development of the financing industry, most of our country's enterprises in the financing to make judgments more scientific and reasonable, for example, they are accustomed to consider the impact of target leverage ratio. But there are some shortcomings, is the current debt market in our country, the application of market timing is not very sufficient, need to be further improved, this paper also points out some phenomena and suggestions.

Although the timing factors can bring great benefits in some time, but from the overall situation, it also indicates that China's debt market is not very stable, because the time factor has also brought a lot of problems.For example, some companies use this factor to allow more people to invest the final stock quilt phenomenon.So China's market has a lot of room for development, there are a lot of things that are not real.

## 4.2 Relevant Suggestions based on the Conclusions of This Paper

### 4.2.1 Based on the Enterprise Operator's Point of View

First of all, business operators should be based on the attitude of the shareholders, the company's debt level control in a relatively reasonable range. According to the previous research and the analysis of this paper, our various industries have a relatively efficient capital structure, the enterprise should try to maintain the company's capital structure at the effective level. The low debt ratio restricts the scale of the enterprise, which affects the long-term development of the enterprise, and the high debt ratio will bring the serious burden to the enterprise management.

Secondly, business operators should always pay attention to the dynamics of the capital market. China's financial industry and capital market has been developing rapidly in recent years. It has provided a variety of financing tools and a relatively good financing environment for Chinese enterprises. Business operators should be more efficient use of capital markets and financial instruments, to accurately grasp the market opportunities.

### 4.2.2 Based on the Perspective of Policy Formulation

First of all, the government should introduce more laws and regulations, to provide the basis for the enterprise in the market activities.

Government departments should use their own mandatory to take effective measures to give some of the market is not reasonable behavior constraints and control, the most effective way is to introduce effective laws and regulations to restrict. Only in this way can purify the debt market, guarantee the debt financing of enterprises are faced with the urgent need of enterprises, rather than those in order to achieve the purpose of some of the enterprises. Therefore, the relevant departments need to gradually improve the existing laws and regulations.

Secondly, the state should pay attention to reduce the direct intervention in the market at the same time. Relevant government agencies, the most fundamental job responsibility is to improve the system of norms existing, put forward some guiding policy, if the debt behavior intervention in the


77

market too much in, but lost its most fundamental role. Therefore, we should improve the operation of government agencies, to recognize their real responsibilities.

## ACKNOWLEDGEMENTS

This research was funded by Jilin University of Finance and Economics (Grant No. 2016B11)

## REFERENCES

Guixin,Han.,2006.Selection of optimal capital structure. *Modern Management Science*4:31-32.
Lanbiao,Liu.&Gongmin,Li.,2012.Chinese applicability of market timing theory -- Empirical Analysis Based on listed companies from 1998 to 2003. *Finance And Economics Research* 11:17-28.
Zhiqiang,Wang.&Bo,Li.,2009.TPO market timing persistent effect on corporate capital structure. *Securities Market Herald* 3:69-74.

SCITEPRESS
SCIENCE AND TECHNOLOGY PUBLICATIONS


78