

## Corporate Capital Structure and Financing Methods Analysis

Eric Jiang

Crean Lutheran High School, Irvine, 92618, Ca, United States of America

**Keywords:** Ownership structure, Financing methods, Corporate governance

**Abstract:** Ownership structure and financing mode are not only two necessary components of enterprise capital structure, but also two basic levels of corporate governance structure. Equity and financing are not only two basic means of survival, but also two alternative corporate governance structures. From the perspective of enterprise capital structure, equity structure is the institutional arrangement and result of enterprise equity capital, which determines the distribution of shareholders' rights, responsibilities and interests and the effect of decision-making behavior. It belongs to the original structure of capital structure. The financing mode is the institutional arrangement and result of debt capital financing, which determines the distribution of creditor's rights, responsibilities and interests and the effect of decision-making behavior. It belongs to the derivative structure of capital structure. From the perspective of corporate governance structure, equity structure constitutes the basis and basis of equity governance. It is the institutional arrangement and important carrier to decide shareholders to play their role in corporate governance. It belongs to the internal structure of corporate governance. The financing structure constitutes the basis and basis of creditor's rights governance, and it is the institutional arrangement and important carrier for creditors to play their governance role. It belongs to the external structure of corporate governance. Shareholders should not only weigh the financial leverage effect, tax avoidance benefit effect and bankruptcy cost effect brought by debt financing, but also make use of the corporate governance effect (incentive and supervision, control transfer) and information transmission effect brought by financing. Therefore, different financing structure is the result of different debt financing decisions that shareholders (managers) choose to achieve their interest goals, and also reflects the different risk preference attitudes of shareholders (managers) to debt capital. The ownership structure is the institutional arrangement that determines the motivation and ability of shareholders to exert influence on the decision-making behavior of enterprises, as well as the way and effect. Therefore, this study has important theoretical value and practical significance.

### 1. Introduction

#### 1.1 Corporate Capital Structure

Corporate capital structure is an essential part of the development of a company's growth, net incomes, and future operations. Capital structure is the basis of corporate governance; Among all the factors that affect the growth of an enterprise, the ownership structure is undoubtedly the most important institutional factor, because the ownership structure is related to the arrangement of the rights, responsibilities and interests of shareholders, which is the most important capital provider of an enterprise. It is an important carrier to reflect the intention of shareholders and determine the behavior of shareholders. The degree of equity balance is another dimension to describe the characteristics of the amount of equity structure in an enterprise. It refers to the degree that the equity of an enterprise is dispersed among the majority of shareholders. It directly reflects the trend that the number of equity is dispersed among shareholders. In essence, it reflects the mutual restraint and balance of rights, responsibilities and interests among shareholders. It can be seen that the degree of equity balance and the degree of equity concentration are just two important opposite dimensions to describe the

quantitative characteristics of equity structure. Similar to equity concentration, according to the degree of equity balance, the equity structure of enterprises can be divided into three types: high balance, moderate balance and low balance. According to Thomas, “these financial pressures are translated into the operations of corporations through the enveloping regime of maximizing shareholders values as the primary objective. Agency theory had provided the rationale for this project.” (2010)

## **1.2 Meaning of Financing**

Enterprise financing refers to an economic activity in which an enterprise, based on its assets, rights and interests and expected income, uses internal accumulation or raises funds for project construction, operation and business expansion from its investors and creditors through certain channels and ways. In order to achieve effective financing, enterprises need effective management of financing quantity and financing structure, which can not only meet the necessary funds for enterprise production and operation and investment expansion, but also optimize financing structure and reduce financing cost and risk. The management of the amount of financing is mainly based on the needs of production and operation, investment expansion, their own financial situation, as well as legal provisions and other factors. The management of financing structure is a more complex and key content in enterprise financing management, and also the main content of enterprise financing theory research. Generally speaking, the theoretical research of financing structure has gone through three stages. The first is the early financing structure theory, which makes a beneficial analysis of the relationship between the cost of equity financing and debt financing and the market value of enterprises, providing conditions for the emergence and development of modern financing structure theory. The second is the modern financing structure theory, which takes Modigliani and Miller MM theory as the starting point, and studies the relationship between financing structure and enterprise value with more strict and scientific methods, which lays the foundation for the development and application of financing structure theory. The third is the new financing structure theory, which relaxes the assumption of complete information, introduces the condition of asymmetric information, and deepens the research of enterprise financing, and gradually combines it with practice (Pan, 2012).

## **2. Corporate Capital Structure**

### **2.1 Common Shareholding Distribution (67% 52% 34% 10%)**

A 67% shareholding is equivalent to absolute control, which is close to 100% power. It allows shareholders with absolute authority to take charge of amending the company's articles of incorporation, merging/separating, changing major business projects, and other major decisions. 52% shareholding is equivalent to relative control, allowing them to make decisions on simple matters, hiring independent directors, electing directors, chairman of the board, hiring review bodies, hiring an accounting firm, and hire/fire the general manager. If the company wants to go public, after 2-3 dilutions, it can also control the company. When the shareholder's shareholding is more than one-third (34%), he/she has veto controlling power, i.e., one veto power. And shareholders with more than 10% of shares have the right to demand the dissolution of the company.

### **2.2 Definition of VIE Structure**

The variable interest entity refers to a legal business structure in which investors will have absolute controlling interest no matter the owners do not have a majority of voting rights. The VIE capital structure will be an effective structure for companies to use when they are preparing to go public in the next following years. By having this type of structure, business owners are able to get close control over their companies and they also can raise capital easily by issuing stocks without giving up their controlling interest towards their companies. The VIE structure promotes the circulation of funds in the international market. The reasonable default of the existence of the VIE structure is conducive to attract

investment by internet companies, while strengthening the cultural output of the country and companies, thereby guiding and supervising ideology. VIE structure has many advantages. The first one is a tax refund. VIE can successfully avoid the current non-convertible foreign exchange control system. A company established in Cayman island can enjoy huge tax exemption and low cost tax transfer. Second, it can help foreign capital effectively avoid government regulation. By setting up shell companies overseas and using the assets of domestic enterprises for reverse packaging, the overall assets are finally packaged and listed overseas, which not only effectively avoids the supervision of domestic regulators, but also enables domestic enterprises to successfully finance in the US capital market (Gavin, 2010).

## **2.3 Equity Incentive**

### **2.3.1 Definition and Analysis of Equity Incentive**

In the early stage of development of startups, capital is tight, which leads to talent loss, especially the senior management and core employees of the company, whose loss can cause valuable impact for the startup. However, entrepreneurs developed a way to provide long-term incentives to other company members, including senior management and core employees, thus reducing the brain drain-equity incentive. Equity incentive, also known as option incentive, is a long-term incentive mechanism implemented by enterprises to motivate and retain core talents and is one of the most common methods to motivate employees. Equity incentive is mainly to conditionally give employees part of the shareholders' rights and interests to have a sense of ownership. Thus, forming a community of interests with the enterprise. They were promoting the expected growth of the enterprise and employees, thus helping the enterprise to achieve the goal of long-term stable development.

### **2.3.2 Differences between Equity and Stock Option Incentives**

Regarding the difference between equity and stock option incentives, we have to determine the difference between equity and options first. Equity is the right of shareholders to receive economic benefits from the company and to participate in the management of the company based on their status as shareholders, while options are the rights granted by the company to certain persons to purchase a certain number of equity or shares in the company at a predetermined price and conditions within a certain period of time in the future. In practice, both “equity” and “options” are used as incentives, which are decided by the company, and the main factors to consider include the company's equity structure, cash flow situation, and the demands of the incentive recipients.

## **3. Analysis of the Company's Financing Model**

### **3.1 Debt Financing and Equity Financing**

There are two main types of financing for businesses, debt financing, and equity financing. Debt financing refers to the funding for an enterprise by raising debt. The enterprise needs to pay interest and repay the principal to the creditor after the borrowing is due for the funds obtained from debt financing. Equity financing refers to the financing method of introducing new shareholders through a capital increase through the transfer of partial ownership of the enterprise. The company does not have to repay the capital and interest, but the new shareholders will share the profits and growth of the company with the old shareholders (Huang, Zhang & Lee, 2019).

#### **3.1.1 Analysis for Debt Financing and Equity Financing**

Whether it is equity financing or debt financing, it relies on the right to claim the future cash flow of the enterprise as a whole, and the evaluation of whether this right can be fulfilled depends on the risk of the company's overall operation, while the risk itself is diverse, and various factors interact with each

other and the asymmetry of information makes it impossible to accurately judge the value of the enterprise, and investors usually hedge the risk by a certain discount. This actually raises the cost of corporate financing. With asset-based financing, it is relatively easy to evaluate the value of assets and help reduce the discount of assets caused by information asymmetry, so financing with asset-based credit instead of overall corporate credit is likely to reduce financing costs.

### **3.1.2 Selection between the Debt Financing and Equity Financing**

Simply put, issuing bonds means that the company borrows money to pay back the interest, and the principal and interest that the company pays back at the end of the bond is predictable and limited. Issuing equity is when the company exchanges its shares for money, bartering, there is no such thing as paying back the money, however, the existing shareholders' shares will be diluted and will share the benefits in the future. When the company grows well, the company will appreciate in value and the shares will be worth more. For example, if a company raises \$1M and doubles its value after a year, the principal plus interest on the bond will be \$1.1M, but the \$1M in shares a year ago will have appreciated to \$2M. That is, when the company is expected to appreciate significantly in the future, it is more expensive to issue shares than to issue bonds. On the other hand, when a company is not willing to issue shares to finance, it may be that the company's share price is undervalued, originally a share of fair value is \$50, now the market value is only \$40, the same financing \$1M, at this time is not willing to issue shares because it will dilute more existing shares. According to MM theory, bonds benefit from a tax shield compared to stocks, so issuing more bonds will lower the total cost of financing and lower the WACC (weighted average cost of capital), increasing the value of the company. However, issuing too many bonds will also increase the distress costs. So each company has its optimal ratio of debt to equity to maximize its value.

## **3.2 Differences between Debt Financing and Equity Financing**

### **3.2.1 Different Risk**

For companies, the risk of equity financing is usually less than the risk of debt financing. Compared with the development of corporate bonds, the return of stock investors on dividends is generally determined by the company's profitability and development needs. The company does not have a fixed pressure to pay interest. The common shares do not have a fixed maturity date. Therefore there is no financing risk of debt service, while companies issuing bonds must assume the obligation to pay interest on time and maturity. When a company does not operate well, it may face enormous pressure to pay interest and repay debts, leading to bankruptcy due to a broken capital chain.

### **3.2.2 Different Financing Costs**

Theoretically, the cost of equity financing is higher than debt financing because: on the one hand, from the investor's point of view, investing in common stock is riskier and requires a higher rate of return on investment; on the other hand, for the financing company, dividends are paid out of after-tax profits and are not tax-deductible, and the issuance costs of stocks are generally higher than those of other securities, while the interest costs of debt financing are pretax. The interest expense of debt financing is charged to pretax and is tax-deductible. Therefore, the cost of equity financing is generally higher than the cost of debt financing.

### **3.2.3 Different Impact on Control**

Although bond financing increases a company's financial risk capacity, it does not reduce shareholders' control over the company. Suppose equity financing is chosen for funding. The equity financing will dilute the company's existing shareholders' control over the company. Companies are generally reluctant to raise funds by issuing new shares. Because with the issuance of new shares, the

number of common shares in circulation will undoubtedly increase. This will lead to a decline in earnings per share and share price, which will harm existing shareholders.

### **3.2.4 Different Roles for Companies**

The issuance of common stock is the company's permanent capital, which is the basis for regular operation and risk resistance. The increase in principal capital is conducive to increasing the credit value of the company and enhancing its credibility, which can provide strong support for companies to issue more debt financing. By issuing bonds, a company can obtain the leverage gain of capital. Regardless of the company's profit, the company only needs to pay the pre-agreed interest to creditors, and the claim can be deducted as a pre-tax cost. When corporate profits increase, companies can obtain more substantial capital leverage gains by issuing bonds. They can also issue convertible bonds and redeemable bonds to flexibly and proactively adjust the company's capital structure, and its capital structure tends to be reasonable.

## **3.3 Private Equity**

### **3.3.1 Definition of Private Equity**

Private equity (PE) refers to equity investments in non-public companies through private equity funds. In the process of transaction implementation, PE will incidentally consider the future exit mechanism, i.e., exit profitably through the company's initial public offering (IPO), mergers and acquisitions (M&A), or management Management by Objectives (MBO). In simple terms, private equity investment means that private equity investors look for outstanding high-growth unlisted companies. Then, inject capital into them, acquire a certain percentage of their shares, promote the company's development and listing, and make profits by transferring their shares after that. Private equity can optimize the capital structure, and can exaggerate a company's capital strength as well as change the situation in which many companies rely too much on internal financing (Timmons & Bynrave, 2016).

### **3.3.2 Strategic Investors**

Enterprises can choose financial investors or strategic investors for cooperation. Still, they should understand the characteristics and advantages, disadvantages of financial investors and strategic investors, their different requirements for investment targets, and choose the right investors by combining their situation. Strategic investors are companies in the same or related industries of the inducing company. Strategic investors are usually preferred if the induced company wants to obtain the investor's support in company management or technology while reducing financial risks. The strategic investors help to improve the company's credibility and industry position while allowing access to technology, products, upstream and downstream businesses, or other complementary aspects to strengthen the company's profitability and profitable growth. Moreover, the strategic investor can provide further funding when the company has additional capital needs in the future. Strategic investors have a longer investment horizon than financial investors because any equity investment made by a strategic investor must be consistent with its overall growth strategy. For example, many multinational companies invest in industries in China because they see the Chinese market, research resources, and cheap labor costs. As a result, strategic investors will have more control over the company and requirements regarding board ratios. They will be more involved in management, making it more difficult for the two partners to integrate in terms of management and corporate culture (Berle & Means, 2012).

### **3.3.3 Financial Investors**

Financial investors refer to private equity funds. Funds are necessarily not industry experts, and some investment funds have an industry bias and extensive industry experience and resources.

Financial investors and strategic investors have three different requirements for the companies they invest in: control of the company, importance of return on investment, and exit requirements (length of time, method). Most financial investors only contribute capital and are generally not involved in the day-to-day management and operations of the company, except at the board level, where they are interested in major strategic decisions and are unlikely to be potential competitors. Once invested, it is difficult for financial investors to control their investment, so it is critical to select investment targets that are well managed, have high growth potential, and have a trustworthy management team. Financial investors focus on medium-term (usually 3-5 years) returns on their investments, with listings as the primary exit mechanism. This is the only way to have liquidity in the funds they manage. Therefore, when selecting investment targets, they will examine whether the company's performance will meet the listing requirements in 3 to 5 years. In that market, its equity structure is suitable for listing, and their experience and network in finance will facilitate the company's future listing.

### **3.4 Listing Financing**

In essence, capital market financing is a way for the owner of a company to sell some of the equity he can receive in exchange for the much-needed development funds, relying on the capital market for short-term blood transfusion to make the company's pie bigger quickly. In the long run, financing is the means rather than the ultimate goal of the enterprise. Through the availability of effective capital, financing points to the competitive advantage of the industry chosen by the enterprise or the industry to be transformed, and further points to the maximization of profits and the ultimate return of shareholders' value. Enterprise can use this move to expand the influence of the market and establish opportunities for market-based restraints mechanisms to achieve sustainable development (Gavin,2010).

#### **3.4.1 Analysis of Listing Financing**

There is a PE multiplier effect when a company goes public, i.e. if the PE multiplier is 50 times, then a company can raise \$50 for \$1 profit. Going public can instantly turn a small, unknown company into a star company, a public company, and the star effect allows the company to raise the money it needs. From a formal point of view, the enterprise listing can use some "free" money, that is, no capital and interest repayment, but the enterprise has to give it a certain amount of equity, and in the better, the enterprise operation, also give it dividends. In addition, after the enterprise is listed, the equity has value and can be used as a means of payment when acquiring other enterprises. Increase the liquidity of shareholders' assets After an enterprise goes public, the shares become a liquid value. In short, going public allows the company to have permanent capital raised, no maturity date, and no pressure to repay the capital. However, there are many risks associated with going public. First, the cost of going public is huge, including corporate restructuring costs, intermediary fees, brokerage underwriting fees, and roadshow costs. For example, some small and medium-sized enterprises may only have a profit of 20 to 30 million dollars a year, but the explicit and implicit costs of the listing process are more than 20 to 30 million dollars, which brings huge financial risks to the enterprise. Second, going public means selling a business, and selling a business means transferring part of one's shares to others, which will definitely weaken certain control. Third, after the company is listed, everything has to meet and vote, such as some must go through the shareholders' meeting, some must go through the board of directors, and the shareholders' meeting, the board of directors is not just open. Thus, it takes a month to solve something that could be solved by one person's decision in one minute. Therefore, if a company often needs to make major decisions quickly, then it is not appropriate for it to go public.

## **4. Analysis of Equity and Financing Problems**

### **4.1 Reasons for Different Financing Tendencies**

We can choose the proper financing method for the company by the size of the company. Large companies are relatively mature, and changes in capital flows in the ordinary course of business are generally not significant. The most common is the capital demand for further expansion of the enterprise, which can be partially solved by internal financing, debt financing, and equity financing. However, for SMEs, many uncertainties affect the development of the business, and the growth of the company is relatively not very stable. At the same time, as the entrepreneurs themselves are less risk-resistant, they usually choose the equity financing method first, which can transfer part of the risk to the investors. The company could also choose the best financing from the consideration of costs. The cost of equity financing is much higher than the cost of debt financing, which is caused by many factors, such as debt being safer (collateral, priority payment, etc.), and the expectation of return is relatively low. Therefore, in terms of cost, debt financing is more cost-effective. In addition, the fees for equity financing (such as investment banking fees, etc.) are also much higher than those for debt. In conclusion, equity and debt are not conflicting financing methods per se but are more often used together in reality. To optimize a company's capital structure, a company needs to achieve the lowest cost of capital and the highest return on investment. If a firm has a single bias toward equity, the cost of capital is too high because there is no leverage, and the return on investment drops dramatically. It is desirable to achieve some moderate and healthy balance between the two.

#### **4.2 Analysis of the Problems of Corporate Finance**

In terms of direct financing, given the strict requirements for listing, it is difficult for SMEs to enter the main board market to a large extent, so equity financing is not very realistic for them; and in terms of debt financing, due to the restrictions on the size of the issue, and because of their small size and high risk, SMEs are difficult to be favored by investors, so it is not easy for SMEs to obtain funds through debt financing. From the company's point of view, a US IPO is more expensive than the average company can afford, with commissions from investment banks, fees from lawyers, accountants, and other professionals during the IPO process, and fees resulting from post-IPO regulation (primarily the Sarbanes-Oxley Act, introduced after the accounting scandal about a decade ago). Many companies are now considering delisting and becoming private again. Those that aren't (like Facebook and the newly listed Twitter) are delaying their IPOs as long as possible, allowing many "alternative trading markets" outside the traditional stock market (like trading platforms like SecondMarket) to find opportunities. The U.S. is litigious, and management and directors of public companies are often sued by shareholders, usually after a stock price crash. Still, even after a 10% drop, someone who has lost money has the slightest leverage to sue.

#### **4.3 How to Optimize Financing Methods and Equity Structure**

The first is to optimize the regulatory policy, listed companies should further strengthen the market supervision of listed companies' share allotment and additional financing, and regulate the financing behavior of listed companies. For financing qualification, it can consider using return on assets as the main assessment index, expanding the current single index assessment for approval to a multi-index assessment, transforming the confirmation of equity financing qualification, and increasing the difficulty for listed companies to allot shares and issue additional shares. Secondly, change investors' investment philosophy. The company can introduce more institutional investors, change the investment philosophy of investors, make them take the road of rationalized investment, make investors pay more attention to the operation status and earnings distribution status of the invested enterprises, and promote investors to rationalize the financing decision of listed companies. With the gradual rationalization of investors' investment behavior and the gradual enhancement of market binding, it will be impossible for listed companies to rely excessively on equity financing, and listed companies must make full use of various financing methods to optimize their capital structure. Third, strengthen the construction of corporate credit. A market economy is a contracting economy, the process of enterprise financing is

both the process of the market and the process of credit. In addition to external factors such as system and environment, the difficulty of enterprise financing by bond market fundamentally depends on the repayment ability and credit level of the bond-issuing enterprise itself.

## 5. Conclusion

This paper presents its own viewpoints, and the research approach and conclusions may be slightly lacking, hoping that it can effectively solve the financing problems faced by SMEs, and also provide reference values for SMEs. Small and medium-sized enterprises are in an irreplaceable position in the economic development of the world. The problem of enterprise financing cannot be accomplished overnight, nor is it only an enterprise problem, but also a social and national problem. It is closely related to the level of development, current situation, and policies of the country, forming a complex problem. Not knowing the SMEs, the financing risk of large enterprises is also imminent. Each company needs to choose to mouth and their own way of financing and equity distribution to have a better future. Only by accurately grasping the causes and the current situation, combined with the financing experience around the world, can we solve and reconcile it with a variety of innovative methods and countermeasures in a certain period of time.

## References

- [1] Thomas, G. (2010). Update on consolidation of variable interest entities: changes for primary beneficiaries, definition of variable interest entity, disclosures. *Bank Accounting & Finance*, Vol 23.
- [2] Pan, J. (2012). Evaluating theories of capital structure in different financial systems: an empirical analysis. Ebook. 1<sup>st</sup>, Pp 11-13.
- [3] Gavin, T.A. (2010). Update on consolidation of variable interest entities: changes to criteria for primary beneficiaries, definition of variable interest entity. *Banking accounting and finance*, vol 23(5).
- [4] Laffont, J. (2002). The theory of incentives: the principal agent model.
- [5] Huang, R., Zhang, W., Lee, K. (2019). The reintroduction of dual-class share structures in Hong kong: a historical and comparative analysis. *Journal of Corporate Law Studies*. Vol 20(1), Pp. 121-155.
- [6] Timmonns, J& Bynrave, W. (2016). Venture Capital's Role in financing innovation for Growth. *Journal of business venturing*. Pp. 161-176.
- [7] Aghion, Tirole. (1997). Formal and real authority in organizations. *Journal of political economy*. Vol. 105(1):1-29.
- [8] Berle, A & Means, G. (2012). *The Modern Corporation and Private Property*. Transaction Books.