

# Discussion on the Influencing Factors of Capital Structure Optimization of Smes

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**Abstract:** Capital structure refers to the relationship between the composition ratio of all liabilities and owner's equity of an enterprise, or the ratio composition between long-term liabilities and owner's equity. Capital structure will infect the choice of enterprise financing behavior, will act on the profitability of the enterprise and the owner's equity, and will have an indelible impact on the terminal value of the enterprise. It is one of the important indicators to evaluate the overall situation of the enterprise. In order to obtain the best capital structure, the ratio of liabilities to shareholders' equity must be balanced among internal and external factors. Therefore, we must first explore the main factors affecting it, in order to optimize the capital structure can be combined with the actual situation to do its best. This paper analyzes the influencing factors of the capital structure of small and medium-sized enterprises, and lays the foundation for improving the capital structure of small and medium-sized enterprises.

## 1. Introduction

### 1.1 Lack of Equity Capital and Unreasonable Debt Structure

China's small and medium-sized enterprises with insufficient scale, less income-generating capacity, coupled with a single source of profits, resulting in slow capital accumulation, the final lack of total capital.

The lack of total capital makes it difficult for smes to make loans and raise funds, which directly limits the further development of smes, especially in the face of emergencies or unpredictable market environment, which may lead to bankruptcy. At the same time, in the process of operation and development, capital accumulation of small and medium-sized enterprises lags behind, leading to external equity financing is hindered.

### 1.2 Information Transmission and Disclosure Standards Are Deficient

Non-standard financial management mechanism is also one of the problems of small and medium-sized enterprises governance, in which the lack of information transmission and disclosure norms makes commercial banks decrease the credit evaluation in order to avoid risks and protect the interests of creditors. In the environment of low profit and difficult living condition, small and medium-sized enterprises usually use the method of cash dividend in the process of information transmission and disclosure, which results in the lack of their own capital, and the only retained earnings are difficult to support the long-term development and expansion. So the non-standard financial management mechanism is also an important factor leading to the unreasonable capital structure.

### 1.3 Stock Structure is Flawed

The common situation of equity structure of small and medium-sized enterprises is that the individual is 100% share-hold, several people share equal shares, the entry and exit mechanism is not clear, and there are no clear rules and so on. The high concentration of equity makes the degree of socialization missing, and when the enterprise expands gradually, this form is difficult to form an efficient incentive for the high-level talents of the enterprise because of the concentration of equity, and the brain drain may appear in the later stage. With this kind of equity structure design, the enterprise own value maximization is difficult to realize.

## **1.4 Exogenous Financing Time Cost and Capital Cost Are Not Low**

Internal financing and external financing are the main financing methods used by SMEs. The advantages of low risk, controllable cost and high efficiency are the advantages of endogenous financing, which make it seem to match the SMEs. Such a relatively safe form of financing is well-deservedly favored by entrepreneurs. However, in China, the proportion of endogenous financing is still not very high among small and medium-sized enterprises, and only at the beginning of the enterprise, the financing results obtained by endogenous financing is the most ideal.

In view of the strict requirements for the listing of enterprises, it is difficult to enter the main market. So equity financing is not realistic. In debt financing, small and medium-sized enterprises are hindered by the size of the issue, and their own size is insufficient, high risk and so on. It is very difficult to attract the attention of creditors. Through debt to finance funds, for small and medium-sized enterprises is not easy.

From the indirect financing situation, bank loans are still the first choice for SMEs to obtain external financing. With the encouragement and support of some related policies, the growth rate of bank loans shows a steady growth trend, which is very much in line with the trend of large enterprises. But it is not denied that the bank loan approval process is complicated. The loan application in the branch needs to be submitted to the provincial branch layer by layer. The intermediate time cost, currency time value will cause problem and need to be considered with. In addition, there is also a certain cost of capital. Once any cost is not fully considered, which will cause cash flow shortage.

From the view of the financing situation of informal financing channels, although private financing and other ways for small and medium-sized enterprises have opened a new channel of financing. But the above informal financing channels will have a counter effect if they are not used properly.

## **2. External Factors Affecting the Optimization of Enterprise Capital Structure**

### **2.1 Economic Environment and Tax Policies**

It is necessary to study the economic environment for capital structure optimization especially the macroeconomic situation. In the good stage of the economy, the relationship between supply and demand in the market is strong. Enterprises are in a stable or even rising time when it can moderately increase debt, take advantage of the development. When the economy isn't doing well, many companies are as if walking on the thin ice. Enterprise should be considering appropriate debt reductions. Capital supply will be affected by monetary and financial policy. When the more tight monetary policy is adopted, the market interest rate will be on the high side, resulting in an increase in the cost of the amount of debt when enterprises can appropriately reduce the debt.

The loan interest of the enterprise is allowed to be deducted from income before income tax, as long as there is a relevant loan contract, the interest rate is within the normal range, and the amount is used for the daily operation of the enterprise. The tax baffle effect can obtain the tax avoidance income.

### **2.2 Industry Types and Development Phases**

Capital structure in different industries has their own characteristics. The industry with stable market share, high monopoly, low operating risk industries can appropriately increase the proportion of debt. So that financial leverage can play a maximum role. The industry with fierce competition, high investment risk or high-tech nature reducing the proportion of debt is the best choice.

The different stages of development of enterprises will also affect capital structure. At the beginning, the risk of operation was too high and the unstable factors were dense when excessive liability is not reasonable. When the development is in the rising stage and even reaches the peak of maturity, the cash flow is fully reliable, and the turnover rate is advancing steadily, it is the best

time to exert the financial leverage effect by increasing the debt ratio. Otherwise, reducing the proportion of debt, maintaining a reasonable ratio of assets and liabilities to ensure the smooth operation of the core function is better choice.

However, some industries have particularity in the speed of capital recovery, such as the construction industry. According to statistics, the construction industry ranked third among the three industries with the highest debt ratio. Because construction enterprises often need to give priority to advance funds in construction and other links. The project account receivable returns slowly as the heavy asset capital model. Its profit level is lower with the increasing raw materials and labor prices which also pushed up the debt ratio. Even at different stages of development of the same enterprise, the capital structure needs to be considered according to the actual situation.

### **3. Internal Factors Influencing the Optimization of Enterprise Capital Structure**

#### **3.1 Asset Structure of Enterprises**

Asset structure refers to the proportion of assets and total assets. Different allocation of assets will bring different risks to enterprises. The setting of asset structure should meet the needs of production and operation, and at the same time, it can reduce the operating risk to the minimum. More importantly, different asset structures also play a role in the construction of capital structure. The effect of asset composition on the capital structure of an enterprise has several aspects:

When the enterprise has more short-term assets, the short-term assets can be activated in a short period of time to achieve value. Therefore, the estimated market value of such assets is more accurate, because the probability of fair value fluctuation in the short term is low. At this point, they either have less debt or rely more on current liabilities to finance their funds.

When the enterprise has more fixed or long-term assets, the enterprise will face greater market risk because of the difficult conversion of such assets. They need to enter the market to complete the transaction. It needs a longer period of time that they can complete the turnaround and realize their value. The longer the time, the more unpredictable the market changes, the more difficult it is for enterprises to predict the market. Because the products or services provided by fixed assets have stable and single attributes, once the market demand changes, the products that can be processed or the services provided are difficult to sell, resulting in the formation of non-performing assets. But these types of companies tend to be more indebted due to the high value of assets and collateral. So company with more fixed or long-term assets often holds long-term liabilities, issuance of shares and other ways as financing channels.

Small and medium-sized enterprises with light assets and intangible assets are often under-indebted. But it is worth noting that no matter whether the business is in good condition or not, intangible assets and fixed assets, its transfer value as an immutable cost, continuous and stable generating every year. So, to some extent, the operational risks of physical assets may be more manageable than intangible assets.

#### **3.2 Preference for Rights and Risks by Business Owners and Management**

The structure of the capital structure is ultimately designed in accordance with the command of the owner and operator. From the shareholder's point of view, if the equity of the enterprise itself is not concentrated, equity capital financing may be used more for this type of enterprise to disperse the business risk. If the degree of centralization is high, the shareholders value the control of power. The enterprise can consider establishing a reasonable equity structure, increasing shares, mutual shareholding strategy, establishing anti-takeover clauses, or financing funds through debts. Through the above way the enterprise can achieve the goal of preventing the dilution of controlling rights.

From the point of view of the management of the enterprise, the management may be dismissed because of the high financial risk caused by excessive liabilities. Therefore, equity capital financing with low financial risk and no fixed interest burden, or low debt financing with low financial risk, is the preference of conservative and steady management. For aggressive, pro-active owners and management, they are more interested in debt financing.

### **3.3 Enterprise Stability and Growth**

If the enterprise with a state of high continuity of production and operation, a higher level of inventory turnover, balanced capital occupation, a certain solvency, can appropriately increase the proportion of liabilities. If the enterprise in a longer period of time with a faster development speed, high efficiency, high value-added ability, small technological risk, strong market orientation, high technology conversion rate, especially innovation or frontier enterprises, can choose high debt financing at the right time.

For small and medium-sized enterprises with horizontal integration, in order to reduce costs, improve competitiveness, expand the scale of production and form a joint venture with peers, through acquisition forming forward integration or backward integration based on property rights relationship, improve the structural level of the system. This strategy improves economic efficiency and gives enterprises the ability to collect and process information better than other enterprises, and competition and hostility will naturally decrease. Therefore, the debt level of enterprises can be raised appropriately.

However, due to the increasing difficulty of management, the strategic management chain involves a wide range. The coordination relationship is complex. It depends on the strengthening of internal activities of the enterprise, and sometimes the cost is more expensive than the external search for resources. It will also bring certain risks to the capital structure of high debt.

### **3.4 Financial Position and Credit Rating of the Enterprise**

Financial management is not perfect, transparency is low, authenticity is poor. These are a series of problems existing within small and medium-sized enterprises. Because the property management consciousness is insufficient, the accounting system is not perfect, the investor's investigation to the small and medium-sized will increase. The low credit rating and the lag of credit system construction are also the important conditions that affect whether enterprises can obtain debt funds. Because of the lack of strict credit system construction and the depletion of reliable credit tracking, while undertaking huge credit losses, the credit environment of small and medium-sized enterprises has not been developed in a favorable direction.

### **3.5 Turnaround and Liquidity**

Inventory turnover can reflect the efficiency of each part of management in purchase, production and sale of enterprises and the debt service and profitability of enterprises are also affected by it. Overall, the better inventory turnover represents a stronger liquidity position. Because multiple turnover brings sufficient cash flow when the probability of inventory backlog occurrence is small. The efficiency of the use of funds can be reflected. On the contrary, if the profitability is poor, it becomes very difficult to obtain funds through equity capital, such as retained earnings which resulting in a large proportion of liabilities. When enterprises have more sufficient retained earnings, financing channels can be more selective. For manufacturing enterprises, because they have more long-term assets such as plant, machinery and equipment, long-term liabilities or stock financing can be considered.

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