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The Financing and Corporate Governance Effect of Issuing Corporate Bonds by Listed Companies

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ABSTRACT

This paper pays attention to the issuance of corporate bonds to explore the effect of corporate bonds of listed companies on the financing and corporate governance. We find that the costs of issuance of corporate debt financing are still higher than the cost of equity financing. Corporate bonds of listed companies in China still can not change the "preferences for equity financing" in a short time. But the bond financing for the improvement of corporate governance will help improve corporate performance.

1 Introduction

To meet the development needs of the corporate bond market, and regulating the issuance of corporate bonds behavior, promoting the coordinated development of the capital market, China Securities Regulatory Commission formulated and promulgated the corporate bonds issuance in 2007. In the initial, the pilots are limited to companies in Shanghai and Shenzhen Stock Exchange Company and the Corporation within the territory who issue overseas listed foreign shares. The acts come into effect on August 14, 2007. The promulgation of "Trial for corporate bond issuance" makes a strong market response. Jin Di Group (600383) released the first motion of the Board through the issuance of corporate bonds, followed by Yangtze Power (600900.SH), Hua Neng Guo Ji (600011.SH). On October 12, 2007 Yangtze Power had be the first to get access to corporate debt issuance. Closely followed by Jin Di Group who's application of issuing of 1.2 billion corporate bonds through the assertions of the China Securities Regulatory Commission, becoming the first real estate listed company to issue corporate bonds on October 18, 2007.

From the late 80s China began to develop corporate bond market, but in general, the corporate bond market has not been fully developed, its growth rate was far slower than the stock market. As table 1 indicates, the scale of annual issuance of corporate bonds, hovering between 200 billion ~ 30 billion Yuan for a long-term. From 2001, corporate bond market began to expand gradually, with a breakthrough in 2005, and get a peak in 2006, the issue scale reached 101.5 billion Yuan, and the stock scale reached 283 billion Yuan. However, so far to 2006, the funding from stock market still had the overwhelmingly status. As of the end of 2007, 9, the ratio of balance of corporate bonds of total market capitalization and equity is only 1.62%. In the mature international capital market, bond market financing is usually much larger than the size of the amount of the stock market financing, corporate bonds accounted for the center of various financing methods. For example, the size of U.S. corporate bonds issue was about 6.5 times the size of stock offerings in the first quarter of 2007.

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Table 1 China's listed companies debt and equity issuance over the years

Unit: billion Yuan

	1999	2000	2001	2002	2003	2004	2005	2006
Bond issuance	200.00	63.00	147.00	325.00	358.00	327.00	2046.50	3938.30
Equity offerings	944.56	1523.73	1252.34	961.75	1357.75	1510.94	1882.51	5594.29

Source: China Securities and Futures Statistical Yearbook 2007

Huang and Zhang (2001) indicated the existence of equity financing preference of listed companies in China, the direct financing of listed companies achieved primarily through equity financing. According to the survey of Lu and Gao (2003), policy factors are accounting for the main reason of listed companies not issuing bonds. For instance, the requirements for issue bonds made by the Commission are too high for the company. Then the listed companies, who never issue corporate bonds before, are so active in applying for issue bonds during the pilot of "Trial for Corporate Bonds". The question is what is advantage of the corporate bonds compared to the previous enterprise bond?

2 Why Not Choose Bond Financing in the Past

2.1 Strong government regulation

For a long time, the management of government bonds has been the implementation system of "the scale of control, centralized management, and hierarchical approval". If an enterprise was going to issue bonds, tending to only focus on how to get government approval, rather than on improving their own business conditions which resulted in inefficient use of funds. Because there is a highest rate limit of issuance of bonds, on the one hand, it leads to excessive demand for the issuer to issue bonds to raise funds, but lacking of investor enthusiasm for investing in bonds, which reduces the supply of funds from the bond market, which suppress the motivation for listed companies to issue bonds. On the other hand, to a certain extent, the interest rate limits overshadowed the quality difference between enterprises. The company does not care its credit, set the highest rate, resulting in high cost of high-quality bonds, and not involving risks by general revenue bonds. It does not meet the market principles- "high-risk, high return, low risk, low income", and not conducive to the formation of a complete financial market risk structure of interest rates. The defect of this risk structure, leading investors can not make a good trade-off between the risks and benefits, and the allocation of resources deviations from the Pareto optimal.

2.2 Securities market development mode constrains to issue bonds of listed companies

China's securities market is in the process of economic transition, led by the Government, so the stock market not only makes function of cash facility and resource allocation, but also shoulders the task of economic reform.

Since stock market plays an important role of consummating structure of corporate governance, raising cash and so on, while the bond market ensure the goals of making up for the central government deficit, strengthening infrastructure, expanding domestic demand to ensuring the goals of economic growth, which make bonds market the part not taken seriously, the development is inhibited, either.

2.3 Inadequate internal governance and constraints of bank loan

There are a lot of listed companies reorganized by state-owned enterprise, due to the dominance of state-owned equity, the absence of state-owned shares and the uncalculated of state-owned shares cause the imperfect corporate governance. Specifically, state-owned shares accounting for a significant proportion in listed companies, minority shareholders don't have the conditions to implement internal governance. The state as a major shareholder delegate the right to the manager, the commission also is the agents, who make their own interests in mind.

The internal control mechanism can't make effective functioning, which plays a direct consequence of huge agency costs, agents use their powers to refrain from supervision and restraint. At the same time, underdevelopment of capital markets and relatively concentration, weak liquidity of equity make external control useless, should this, internal control and external control invalidated. Second, Treatment of debt financing contains debt financing with debt management and bankruptcy factors, debt is different from the equity, the borrower should pay back when the debt service due, otherwise, companies could face bankruptcy or credit loss.

Face the challenge, the managers should not only make investment decision carefully, but also save the expenditure in order to meet interest payment and reduce the basic possibility of bankruptcy, thereby preserve their own authority. So, the bank should be a valid aspect of debt constraints. However, on the one hand, governance of the banks has not been resolved, and can not supervise the operating matrices of loan companies. On the other hand, China is led by state-owned banks, government doesn't announce bankruptcy of the enterprises which are unable to pay debts back, or advocates merger between developed business and nearly bankrupt companies for sake of protecting companies.

In this case can debt financing governance exert their effects? Soft constraints enable enterprises pay the debts without pressure, how can it corporate companies' behavior? For bond financing, some of the bond investors are institutional investors, who are in better position to conduct corporate conduct. Other small investors are able to take information of institutional investors as a reference.

2.4 Immature bond market

Firstly, bond primary market has characters of few investors, single species, small issue size; Secondly, the bond secondary market, due to fewer bonds, currency markets are almost not exist, that is poor liquid bonds; Thirdly, as the lack of standard bond rating agencies, the credit rating is a bit confusing, credit rating certificate are issued by the bank, but in practice, the reliability of the results is not guaranteed; Lastly, the ratings for broker are not established, there will be a big risk of the brokerage's assets and the lack of credit mechanism.

3 The Superiority of Company Bond Financing

3.1 Lower cost of financing

Currently, most of the corporate which issue bond is expected with well corporate earnings, strong financing capacity, they consider how to reduce financing costs rather than whether they can get financing. Until 2007, the rate established by the People's Bank of China for more than 5-year is 7.83%. Someone people point that the current cost of financing equity is about 10%. But, coupon rate of bonds issued in 2007 for over 5 years are at 5.35% -5.90%. So, relatives to bank loans and equity financing, issue corporate bonds are relatively low in financing costs for listed corporate.

Table 2 Listed corporate bonds in 2007

Bond Name	Life (years)	Interest rates
07 long power bonds	10	5.35%
07 Marine Claims	10	5.77%
07 Huaneng G1	5	5.67%
07 Huaneng G2	7	5.75%
07 Huaneng G3	10	5.90%

Source: Shanghai Stock Exchange Web site

In addition, the issuer can make choice (redemption terms or resale terms) according to the business strategy, which is not only useful to reduce the financing costs. But also provide a greater operation space for investment. The corporate bonds pilot approach does not explicitly require security, especially for some better quality listed companies, who can issue with unsecured form. For some SMEs with high demanding for funds, they can use third-party guarantees, shareholder guarantees, pledge or mortgage, etc. to enhance the credit risk guarantees to ensure bond financing successfully.

3.2 Extensive use of funds

The reasons for slow development of corporate bonds are lengthy approval process and the stringent control of the use of the proceeds, which makes some enterprises exclude from the bond market. Compared to corporate bonds, corporate debt approval process streamlined. Financing conditions required easily. Issuance of corporate bonds, can apply for issuing in phases. The issuer may release rhythmically based on market interest rates and money demand conditions, which is helpful to reduce financing costs. Meanwhile, use of funds raised of corporate bonds isn't specified, it is no longer linked with certain fixed assets investment projects, as long as the national industrial policy on the line. It can use not only for projecting construction, but also repaying the loan, adding the company liquidity, improving the company's financial structure.

On March 12, 2008, Jin Di Group (600383.SH) issue 1.2 billion corporate bonds successfully. The company claimed it would use 3 billion to repay the commercial bank loan, make enterprise funds as corporate flow, which is useful for debt restructuring.

3.3 Tax receipts

Corporate bond financing allows businesses to enjoy the tax deductible interest. Financing costs and interest expense deducted before tax, as equity financing is not available. Therefore, listed companies issue corporate bond can make tax avoidance reasonable, access to tax-saving benefits, thick the after-tax profit per share.

3.4 Corporate governance effect

Jensen and Meckling (1976) indicated that the operator's degree of effort is an increasing function of its own equity ratio. In order to reduce agency risk, companies need to strengthen the constraints on the operators. Gross and Hart (1982) Gross and Hart (1982) proved that the increase of debt rate in financing will ease the separation of ownership and management experiences resulting from the conflict between shareholders then reduce the agency costs. Jensen (1986), Stulz (1990), Bathala, Moon, and Roa (1994) find that due to the requirements of repay the corporate debt's principal and interest in the contract on time in cash, which will reduce the manager to enjoy personal interests by using free cash flow.

For a long time, the creditors listed companies in China are mainly banks and other financial structures. Song and Yu (2005) find that consider the reality of the situation, bank as the external regulators, should have some control rights, but China's commercial banks serving as the creditors are lack of such rights. The constraints of bank credit on enterprises is not tight, there has always existed a soft budget constraint relationship between Chinese enterprises and banks, resulting in business and credit relationships between banks is difficult to normalize. Under bond financing, as a debtor the company must directly face the creditors who are the majority of its bond investors, then the company is subjected to the supervision of a number of creditors. If the corporate bond issuers can not pay the principal and interest, bond holders will inevitably put pressure directly to the issuer company. For corporate, the debt must be repaid, if not it will face enormous social and economic pressures. Bond is a hard constraint for corporate, bondholders can play supervisory role in the enterprise. In general, the effect of corporate bonds on corporate governance structures in the following three ways: (1) Increasing operator's degree of effort and other actions, and then affecting the company's revenue streams and market value. (2) The size of corporate bond will indicate the company's operating performance and reducing the asymmetry of earnings information between the operator and the outside investors. (3) The size of the provisions of the company's bonds stated the distribution of control rights.

As so far, Chain has basically completed the split share structure reform, some companies are implementing Decreasing-state-owned shares program, the company's ownership structure tends to decentralization, control rights and management rights are further apart. Corporate bond played a positive role in improving the governance of listed companies.

4 Conclusion

This paper analyzes the finance and corporate governance effect of corporate bonds issued by listed companies in China. In the past, the listed companies in China preference equity financing, mainly due to the higher long-term bank borrowing costs than the equity financing costs. At present, the cost of issue corporate bonds is lower than bank loans, while it is still higher than the cost of equity financing. Therefore, from the cost of financing point, the attractiveness of Corporate Bonds is still weaker than equity financing. The listed company will be favor equity financing if it meet the requirements for issue additional stock or rationed shares. The development of the corporate bond market needs further improvement of the capital market itself, but also need strengthen the corporate governance of listed companies.

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