

# A Review of Research on Strategic Differences and Debt Default Risk

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## ABSTRACT

In recent years, more and more scholars have been studying the impact of corporate strategy on debt default, so as to provide enterprises with more perfect strategy differentiation strategy, thus reducing the risk of corporate debt default, and improving the ability of preventing and coping with unforeseen shocks for enterprises with large strategic differentiation, thus reducing the operational risk of enterprises. In this paper, we look at the measurement indexes of strategic differences and debt default risk, as well as the influencing factors of debt default risk, the current status of the research on strategic differences and debt default risk, and put forward governance proposals for debt default.

## KEYWORDS

Strategy; Strategic differences; Debt default risk; Company management

## 1. INTRODUCTION

Nowadays, China is in a critical period of transformation from high-speed development to high-quality development, which puts forward higher requirements for the quality of our economic development. Since 2016, China has stepped into the credit crunch cycle, especially during the epidemic, the downward pressure on the economy has increased, enterprises have fallen into operational difficulties, and the break in the capital chain has made the risk of corporate defaults more serious.

It can be seen that large-scale debt default by enterprises is a huge obstacle to the high-quality development of China's economy. With the increasing degree of global economic integration and informationization, enterprises are facing a severe competitive environment and survival pressure in the industry. In order to stand out in the fierce market competition, more and more listed companies choose to adopt differentiated strategies, i.e., development strategies that deviate from the industry norm, in order to seek better development. However, many enterprises' differentiated expansion ends up in failure, financial difficulties or even bankruptcy. Therefore, this paper reduces the risk of corporate debt default by analyzing the relationship between strategic differences and the risk of corporate debt default to provide strategic guidance for enterprises.

## **2. STRATEGIC DIFFERENCES AND MEASURES OF DEBT DEFAULT RISK**

### **2.1. Indicators for Measuring Strategic Variances**

Strategic differentiation usually refers to the specific differences in strategy between a firm and its competitors, including differences in products, market positioning, technology, costs, branding, marketing, etc. The degree of strategic differentiation, on the other hand, is used to measure the degree of difference in strategy between a firm and its competitors.

Geletkanycz and Hambrick (1997), Tang et al. (2011), and Ye Kangtao et al. (2014) integrate the distribution model of six key areas to determine the strategic layout of a firm, and then reflect the degree of difference between the firm's strategic model and the industry convention. The following six strategic dimensions are used to reflect the indicators of the enterprise's resource allocation :advertising investment, R&D investment, capital intensity, fixed asset renewal degree, financial leverage, and overhead investment. The first four indicators reflect firms' behavior in marketing, expansion and innovation, financial leverage reflects firms' capital operation, and overhead investment reflects firms' expense structure. These six indicators generally show the trend of differences in firms' strategic choices. These six variables are standardized by industry, using absolute values to distinguish each firm on each strategic dimension. Second, the average of the six variables was calculated for each firm implying the extent to which the firm's overall strategy deviates from the traditional industry strategy.

### **2.2. Indicators for Measuring Debt Default Risk**

The following common assessment models are currently applicable to the measurement of corporate debt default risk:

- (1) The Z-Score model, proposed by Edward Altman in 1968, assesses the likelihood of corporate bankruptcy through financial ratios. The model categorizes firms into bankruptcy and non-bankruptcy zones and determines the probability of default based on the calculated Z-Score value. In 1977, Altman et al. extended the original Z-score model to create a second generation model, the Zeta model.
- (2) The Merton model proposed by Robert Merton, of which the KMV model is more widely used. The Merton model assesses the default probability of a firm based on the relationship between stock prices and bond prices. The model treats the value of a firm's assets as an option, and assesses the firm's default probability by calculating the value of the option.
- (3) Logistic regression model is used to analyze multiple factors affecting corporate debt default, such as financial ratios, market factors, etc., which also predicts the default probability of a firm.
- (4) The CART model (Categorical Regression Tree Model), proposed by Breiman et al. in 1984, determines whether a firm will default by constructing a decision tree, which can clearly demonstrate the degree of influence of different factors on a firm's default.

## **3. FACTORS AFFECTING DEBT DEFAULT RISK**

From the perspective of external economic market, Brogaard et al. (2015) pointed out that, improving stock liquidity can help to reduce the risk of debt default of firms, which can be realized through two channels, namely, improving the efficiency of price information and improving corporate governance. Domestic scholars Zhang Qingjun and Bai Wenjuan (2020) use the test results of Chinese A-share market data from 2009-2015 to support the conclusion of Brogaard et al. (2015) that stock liquidity is negatively related to debt default risk in the Chinese market.

External macroeconomic changes also affect firms' debt default risk, Miao Xia (2018) suggests that the better the economic environment, the lower the possibility of generating debt defaults; while the risk of debt defaults increases significantly during economic downturns. Kuehn and Schmid (2014) point out that the likelihood of firms' defaults increases significantly when the macroeconomy is in a recession and that this effect is asymmetric, and economic recovery does not significantly reduce the probability of firms incurring defaults, and each industry is affected to a different extent.

In terms of industry characteristics, the risk of debt default is different for each industry, and each industry has its own characteristics. Yu Yaya and Liao Guanmin (2017) observe that labor-intensive firms have a higher probability of incurring debt defaults when the industry as a whole declines. Guo Pengfei and Sun Peiyuan (2003) found that firms in regulated industries have lower debt ratios due to the monopoly attributes of their operations and their lucrative profits, thus reducing the likelihood of debt default.

Whitaker (1999) has pointed out that many firms are in financial distress more because of their weak management than economic distress. The empirical study of Meng Qingbin, Hou Chuanran and Lu Bing (2019) based on the data of listed companies in China found that corporate innovation investment and debt default risk are in a U-shaped nonlinear relationship, and corporate default risk is negatively correlated with innovation investment when the innovation investment does not reach the threshold level, but when the innovation investment breaks through the threshold position, the increase of innovation investment will exacerbate the risk of corporate default.

Carminchael (1972) explains the causes of financial distress from the perspective of liquidity, and proposes that financial distress arises from the inability of enterprises to fulfill their contracts due to insufficient liquidity. Baxter (1967) argues that excessive indebtedness increases the likelihood of enterprise bankruptcy, and the probability of an enterprise with a stable income falling into the risk of bankruptcy is lower. Lei Shuangcheng (2023) chose A-share listed companies in Shanghai and Shenzhen from 2013 to 2020 as a research sample and found that short-term lending and long-term investment are significantly and positively related to the risk of corporate debt default.

#### **4. CURRENT STATUS OF RESEARCH ON STRATEGY DIFFERENCES AND DEBT DEFAULT RISK**

Barton (1988) used the data of the world's top 500 companies to conduct an empirical analysis, and obtained the following conclusions: if the enterprise diversification involved in the field of non-relevant, then the continuation of these businesses will lead to the enterprise's core competitiveness declining, to a certain extent, increase the enterprise's operational risk and financial risk, and at the same time, enhance the possibility of the enterprise to incur debt default. Ahmed Rialli-Belkaoui, Bannister (1994) showed that compared with listed companies that specialize in business, enterprises engaged in diversified investment strategies tend to have higher gearing ratios, and are prone to debt crises once there are problems with financing. Muhamad and Faisal (2017) argued that, before adopting diversification business models, enterprises have to carry out risk prediction and rationalize the allocation of funds in the process of carrying out diversification, otherwise it will lead to the rise of debt risk due to the decline in operating capacity.

Jing Guo and Xinmin Zhang (2021) found that one of the main reasons for the outbreak of debt default by firms is strategic aggressiveness. Strategic aggressiveness increases a firm's risk of debt default by affecting its investment efficiency, and it also increases the risk of debt default by affecting its gearing ratio. As the aggressiveness of a firm's strategy increases, its defenses in the face of a credit crunch are weakened, and the credit crunch in turn contributes to making strategically aggressive firms more prone to debt default. Zhai Shuping, Sun Xuejiao, and Yan Hongyue (2019) take Chinese A-share listed companies as a sample from 2005-2017, and find that the more aggressive the strategic positioning of the enterprise, the shorter the debt maturity structure, but the financing risk that the

aggressive strategy will also bring. A firm's strategic positioning affects the firm's business risk, the degree of information asymmetry and agency costs, which in turn affects the debt maturity structure. Usually, firms with more aggressive strategies tend to adopt shorter-term debt maturity structures to increase liquidity risk to reduce the degree of information asymmetry and agency costs of the firm. Feng Wang (2022) studied the impact of the degree and speed of corporate diversification strategy implementation on debt defaults with a sample of China's A-share listed firms from 2010 to 2020. The main conclusions are as follows: the higher the degree and speed of diversification and expansion of enterprises, the higher the risk of debt default. With the deepening of the degree of diversification, the enterprise's ability to create endogenous financing and the ability to obtain exogenous financing will be affected, and the speed of diversification will also increase the financial leverage of the enterprise, leading to the behavior of "short-term loan and long-term investment", which will increase the repayment pressure of the enterprise and lead to debt default. Wang Huacheng, Hou Chunran and Liu Huan (2019) take A-share listed companies in China's Shanghai and Shenzhen cities as research samples, and the results show that the greater the degree of deviation of corporate strategic positioning from the industry's conventional model, the strategic positioning differences have an impact on the risk of corporate defaults through the two paths of agency costs and operational risks. Sun Hui and Zhang Ce (2022) chose A-share listed companies from 2010-2019 as the research sample and found that: the degree of strategic difference has a significant positive impact on corporate default risk.

## **5. DEBT DEFAULT GOVERNANCE PROGRAM**

From the internal viewpoint of the enterprise, enterprise managers should have a deep understanding of their own financial situation and clarify the location of the debt default boundary and the characteristics of the efficiency gap indicator when managing financial risks. By analyzing key indicators such as the enterprise's asset and liability structure, cash flow position and profitability, they should determine the maximum level of debt that the enterprise can bear in order to avoid the risk of debt default. In addition, managers should rationally determine the financing structure options, choose appropriate financing methods and tools according to the operating characteristics of the enterprise and the industry environment, and ensure the robustness and sustainability of the financing structure. At the same time, managers need to retain a reasonable margin of safety in financing to ensure that the enterprise has sufficient coping ability in the face of market changes and uncertainties. In particular, they need to pay attention to changes in market interest rates and adjust their financing strategies in a timely manner to avoid over-indebtedness and falling into debt default. Through scientific financial management and risk control, enterprises can effectively respond to the challenges of the external environment and ensure financial health and sustainable development.

External supervision of enterprises is also indispensable, and a reasonable regulatory system is the guarantee for the healthy operation of the bond market. As an important part of the capital market, the bond market needs an effective regulatory mechanism to ensure the stability of the market order and the protection of investors' rights and interests. The relevant regulatory authorities should attach great importance to the institutionalization of the bond market and continuously improve the regulatory rules and systems to adapt to the development and changes in the market. Regulators need to take into account economic policies, market conditions and the actual situation of enterprises to formulate a reasonable management system, including regulations on supervision, institutional framework and information disclosure requirements. These regulations should be able to effectively supervise and guide the behavior of market participants, prevent market manipulation, insider trading and other illegal behaviors, and ensure the fairness, impartiality and transparency of the market. At the same time, regulators also need to actively implement the regulatory provisions, strengthen supervision, inspection and law enforcement, identify and deal with market risks in a timely manner, and maintain the stability of the market order. Through a sound regulatory system and effective regulatory practices, the bond market can better support economic development and corporate financing, and promote the healthy development and stable operation of the market

## 6. CONCLUSION

The above literature discusses the macro-micro factors affecting the risk of corporate debt default in terms of the economic market, macro-environment and industry characteristics external to the enterprise and the internal factors of corporate management, respectively. From the above overview, it can be seen that the default of corporate debt can be affected by many factors, and in order to reduce the risk of default, it is necessary to have the support of a healthy market environment, good policy support, correct leadership decision-making, and perfect internal governance mechanism and other related elements. From the viewpoint of corporate strategic differences, most of the major studies affecting corporate debt default risk are based on corporate diversification, but strategic differences are a broader concept and there is still some room for expansion.

Based on the perspective of internal corporate governance and external regulation, the debt default governance program is proposed. With the high-quality development of China's economy, the continuous development of the capital market, and the continuous improvement of relevant regulatory policies, the factors that have an impact on corporate debt are changing day by day, and future research should be based on a richer policy background, combined with the changes in regulatory policies to explore the factors that influence corporate debt default risk in a more in-depth manner. At the micro level, the extent of the impact of different corporate systems, such as corporate culture, corporate innovation, corporate strategy and other factors on debt default should be further analyzed, combining with the characteristics of enterprises in different industries for in-depth discussion.

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