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Causes and Control of Financial Risk in Mergers & Acquisitions

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Abstract

The mergers & acquisitions (M&A) of enterprises are the management activities with high risks which exist through the whole M&A activity, and the financial risk is the important influencing factor to impact the M&A. By analyzing of value evaluation, financing activity and financial risk in M&A, it is obvious that M&A is a property rights trading with high risk (and the financial risk is the important factor with the highest risk). Therefore, the before-event control and the mid-event control should be applied to prevent the financial risk, and the after-event control should be used to reduce the financial risk, and accordingly enhance the survival rate of M&A.

Keywords: Mergers & Acquisitions (M&A), Financial motivations, Financial risk, Causes, Control

1. Definition and causes analysis of financial risk in M&A

The financial risk in M&A means the possibility that the financial crisis happens in certain term because of the financing for M&A or the debts occurring in M&A. An integrated M&A activity includes the selection of objective enterprise, the value evaluation of objective enterprise, the feasibility analysis of M&A, the raising of M&A capitals, the confirmation of pricing mode, and the integration after M&A. These parts all may produce risk, and the financial risk in M&A mainly comes from following aspects.

1.1 Financial risk when the party of M&A evaluates the value of objective enterprise

The base of M&A is the value evaluation of the objective enterprise. At present, the value evaluation of the objective enterprise in China is the evaluation according the basic principle and method procedures of the asset evaluation, and its rationality is impacted by various factors.

1.1.1 Imperfect evaluation index system

In M&A, a series of effective evaluation index system are deficient in China, and most relative regulations are principled without operation values. The human subjectivity in M&A could largely influence the M&A, so the M&A can not be implemented according to the value rule of the market, and the problem of "erosion of state assets" is hard to avoid, or to avoid the erosion of state assets, the value of the objective enterprise is evaluated too highly to implement the M&A.

1.1.2 Lacking in the agency organization serving for M&A

Because the independent agency organization which can provide exact information and consultation service for M&A, the information costs of both parties of M&A can not be reduced, and the behavior of M&A can not be guided and supervised, and the transaction cost and risk will be increased certainly.

1.1.3 Too much governmental controls in M&A

Some local governments force "matching" two enterprises, and even merged the disadvantageous enterprise into the advantageous enterprise by unreasonable trading price and finally dragged the feet of the advantageous enterprise. The party of M&A was forced to accept not only the losses and debts of the disadvantageous enterprise, but also the employees in the disadvantageous enterprise. The interference of the government not only could make the trading price to deviate the value seriously, but brought large management burden to the party of M&A.

1.2 Financial risk brought by financing activity of the party of M&A

1.2.1 Influence of different financing modes

The financing of M&A generally includes the interior financing and the exterior financing. The interior financing is the own capitals of the enterprise, and these capitals can be freely dominated by the enterprise, and the financing pressure is small, and nothing must be repaid, so the zero financing cost can effectively reduce the financial risk. But new financial risk will be produced when only depending on the interior financing. On the one hand, because the general scale of Chinese enterprises is small and the profiting level is low, it is hard to quickly raise needed capitals only depending on their own accumulations. On the other hand, if the interior financing is largely adopted to occupy the precious flow

capitals of the enterprise, the quick reaction and adaptability of the enterprise for the change of exterior environment will be reduced, and once the own capitals of the enterprise are used for M&A, and refinancing will be difficult, which will endanger the normal management of the enterprise and increase the financial risk. The exterior financing means raising capitals by exterior channels, and it includes the equity financing and the debt financing. The equity financing has its limitations. First, China requires the stock financing rigidly, and long financing time makes against the chance of M&A. Second, the stock financing will inevitably change the equity structure of the enterprise, and dilute the control right of big shareholders to the enterprise, even the big shareholders of M&A may lose the equity of the enterprise. Comparing with the equity financing, the cost of the debt financing is lower, but in the present China, some enterprises have higher debt rate and limited loaning ability, and even the debt financing is successful, the enterprise after M&A will be on a sticky wicket in the competition because of too much debts and deteriorated capital structure. And when the debt is at term, the repayment of capitals and interests will increase the financial burden of the enterprise, and improper arrangement will make the enterprise to get into the financial crisis.

1.2.2 Whether the financial mode accords with the motivations of M&A

The M&A motivations here only mean that the enterprise of M&A wants to hold the objective enterprise temporarily or in a long term. If the target of M&A is temporary to hold the objective enterprise, and resell it after proper alteration to earn the price difference, the quite large short-term capitals should be invested. Here, the short-term loan mode with lower capital cost can be selected, but the repayment burden of cost and interest is heavy, and the enterprise is easy to get into the financial crisis because of improper arrangement. But if the buyer wants to hold the objective company in a long term, the concrete financing mode of M&A capitals should be confirmed according to the capital structure and the requirement of sustainable management of the objective enterprise. Therefore, the M&A enterprise should maintain normal operation capitals, match the investment return terms with the loan sorts, and reasonably arrange the capital structure aiming at the debt repayment terms of the objective enterprise.

1.3 Financial risk in M&A

Though M&A is a short cut for the enterprise to enlarge the scale, enter into other industries or enlarge the market share, but in M&A, because the management concepts, the organization structure, the management system and the financial operation modes of the M&A enterprise and the objective enterprise are different, the friction will occur inevitably, and if it had not been treated properly, not only the profit of M&A will be neutralized, but also the competitive advantage of the original enterprise will be corroded. Especially when the buyer lacks in experiences and the information of seller and buyer are asymmetric, or the seller intentionally or unconsciously hides some very important news for the buyer which has not sufficient apperceiving ability, the buy may taste the “bitter result” in the integration after M&A.

2. Control of financial risk in M&A

The risk control means those endeavors which can minimize the degree and frequency of the risk, and it generally includes the preventing mode and the lightening mode. The intention of t preventing is to reduce the possibility that risk happens, and the intention of lightening is to lighten the degree of risk loss, and the risk preventing includes the before-event control the mid-event control, and the risk lightening is the after-event control.

2.1 Before-event control of financial risk in M&A: carefully select the objective enterprise of M&A

2.1.1 Confirming the strength and position of the party of M&A

Except for emphasizing the value evaluation of the objective enterprise, the enterprise should objectively analyze and evaluate its own strength, especially the capital strength, and reduce the unpractical and blind optimism and aggrandize its own strength. In addition, it should realize that M&A is not only a kind of strategic behavior, but also a kind of economic behavior, and the enterprise should follow the principle of marketilization, not annex some enterprises with heavy debt burdens, supers and historical burdens to obtain the political capitals for some leaders in China, which will make the enterprise after M&A to get in embarrassed situation. Leaders should make decisions rationally from the position to promote the development of the enterprise.

2.1.2 Reasonably evaluating the value of objective enterprise

The asymmetric information of the two parties of M&A is the essential cause to produce the risk of value evaluation of the objective enterprise, so the enterprise of M&A should try to avoid hostile M&A, and carefully check and evaluate the objective company before M&A. The buyer can retain the investment bank to plan the development strategy of the enterprise, capture the objective enterprise, and comprehensively analyze the industrial environment, the financial state and the management ability of the objective enterprise, and reasonably predict the future profit ability of the objective enterprise. The value evaluation of the objective enterprise based on that will be close to the real value of the objective enterprise and reduce the evaluation risk. In addition, the different value evaluation methods can be adopted to evaluate the same one objective enterprise, and different prices may be obtained. The buyer should decide the proper evaluation method according to the motivation of M&A, such as whether the objective company continually exists after M&A, and

whether the information of materials is sufficient.

2.2 Mid-event control of financial risk in M&A

2.2.1 Adopting various financing measures

When the enterprise makes the financing decisions, it should actively develop different financing channels such as the equity financing, the debt financing, the lever purchase financing, and the buyer financing to implement M&A and push the recombination and integration once the value of the objective enterprise is confirmed, and control the capitals structure in a relatively reasonable range. Under this premise, the capital composing and the term structure of the debt can be analyzed, and the future cash inflow and the debt repayment of the enterprise can be composed and matched according to the term structure, and the flow weak point of future capitals of the enterprise can be found out, and then the terms and the sum structure of long-term debt and short-term debt are adjusted to minimize the capital cost.

2.2.2 Adopting the mode of mixed payment

The enterprise should be established in long-term target, and adopt different combinations such as cash, debt and equity for the payment mode, combining with its own financial status. If the buyer predicts that the M&A could obtain large profit space by effective integration, and it can adopt the mixed payment mode giving priority to debt payment, so the tax-offset could reduce the capital cost. And if the buyer has sufficient capitals and stable cash flows, and the cost of stock issuance is large or the stock value of the enterprise is undervalued in the market, the mixed payment mode giving priority to own capitals can be selected. If the buyer's financial state is not good, and the asset debt is high, and the asset flow of enterprise is bad, the share exchange mode can be adopted to optimize the capital structure. Therefore, the enterprises in M&A should deeply develop the mixed mergers, and study to adopt multiple securities such as company bond, convertible bond and warrant for combined payment.

2.2.3 Adopting flexible mode of M&A to reduce the cash payout

The main modes of M&A include following sorts.

(1) M&A of mortgage. The objective enterprise will be the mortgage to apply quite large loans to the bank for M&A.

(2) M&A of debt-undertaking and stock-control. When the debts of the objective enterprise mainly come from bank loans and they are insolvent, the party of M&A can consult with the bank to independently undertake the repayment obligation, and the bank should allow the party of M&A to transfer the debt to the capital stock of the objective enterprise as the capital, and accordingly achieve the holding state.

(3) M&A of stock-melon-cutting. When the asset of the objective enterprise exceeds its debts, the party of M&A needs not buy the surplus asset of the objective enterprise, but should consult with the owner or the asset management institution of the objective enterprise, and add the surplus asset of the objective enterprise into the party of M&A by the stock form, and share corresponding profit according to the share.

2.3 After-event control of financial risk in M&A

2.3.1 Establishing the financial alarm management system

In the integration term of M&A enterprises, because the frequency of financial fluctuation and financial risk happen is higher, so the financial crisis of the enterprises of M&A easily occurs. Therefore, for the survival and development of the enterprise of M&A, the enterprise of M&A should properly establish scientific financial alarm management system to take precautions. The financial alarm management system of the enterprise of M&A is to take the financial risk and financial crisis induced by the financial management mistakes and the financial process fluctuation in the integrated term as the research object, and supervise them in order to ensure the good development of the management state of the enterprise, and identify, evaluate, predict, pre-control and continually remedy bad financial development tendency.

2.3.2 Enterprise division: removing and separation

The removing means that the enterprise lends some existing sub-company, department, product production line and fixed asset to other companies, and return cash or portfolio. The separation means the company distributes the share of the sub-company owned by the parent-company to shareholders in the parent-company according to certain proportions, and accordingly separates the management of the sub-company from the parent-company in law and organization. In the separation process, the cash transaction will not happen, and the transfers of equity and control right to the third party don't exist, and the present shareholders still keep their rights to the parent-company and the separated sub-company. The unadvisable M&A will produce disastrous consequent to the enterprise, and the removing and separation can help the enterprise to remedy false annexation and reduce the financial risk of M&A. In the integration process, when the situation is largely different with the anticipation and the financial state is not stable, such as the performance of the objective enterprise is bad, the party of M&A can not burden the interest, and the stock price of the company falls, the enterprise can remove or separate this sub-company.

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