

Exploring the Company's Risk Management in Equity Investment --Taking Shandong Hanlin's Betting Agreement as an Example

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Abstract. With the full restoration of normalized operation of the social economy, China's equity investment market is hot to pick up. In equity investment, while the investing company obtains greater benefits, there also exists the possibility of loss brought by market risk and non-market risk, so it is necessary to improve the risk management measures of the equity investment company to improve its risk prediction and response ability. It is necessary for investing company to ensure that the investment firm has the ability to deal with all risks that may arise and can proactively address and anticipate them. This paper explores and analyzes the reasons for the failure of Shandong Hanlin's betting agreement, and further summarizes the risk management measures that should be taken by the company in equity investment to promote the healthy and sustainable development of China's equity investment market. At the same time, it also expounds the types of risks that may exist in the investee company, the methods of risk control and the way of selection.

Keywords: Equity investment; betting agreement; risk management.

1. Introduction

On July 9, 2023, the Regulations on Supervision and Administration of Private Investment Funds were officially announced, which attracted widespread attention. Equity investment refers to the behavior of a company participating in or controlling the operating activities of another company through direct investment such as purchasing the shares of that company in order to obtain interests and bear risks. In equity investment, the investor becomes a shareholder of the company and enjoys corresponding interests, which mainly come from the growth of the company's value. However, while the investor obtains greater benefits, equity investment has the possibility of losses caused by market risks and non-market risks, and therefore requires effective risk management. With the rapid development of China's market economy and the increasing improvement of the capital market, the number of equity investments in companies has gradually increased, which has greatly contributed to the rapid growth of companies and improved the level of China's economic development.

Since the beginning of this year, with the full resumption of normalized operation of the social economy, the gradual recovery of market demand and the steady improvement of the national economy, the heat of China's equity investment market has rebounded, with science and technology innovation remaining as the theme of equity investment and the national strategic emerging industries still being the main direction of equity investment. As shown in Table 1, hard technology investment in semiconductors and electronic equipment, biotechnology / medical health, IT and other hard technology investments remained high, with the number of investment cases exceeding 700, of which the investment amount in semiconductors and electronic equipment exceeded RMB 60 billion. Meanwhile, the investment amount of Food & Beverage has increased significantly compared to last year, amounting to 22.348 billion RMB.

Table 1. Industry Status of China's Equity Investment Market in the First Half of 2023

Industry	investment quantity (unit:)	investment amount (uni: million)
semiconductor and ele	813	631.63
biotechnology/medical and health	752	435.48
IT	706	285.25
machine manufacturing	369	176.21
chemical raw materials and processing	218	187.92
clean technologies	159	212.26
internet	141	193.39
car	113	236.76
food and drink	69	223.48

Data source: Table data from Zero2IPO Research Center

Driven by the overall positive macro level, China's equity investment market is recovering moderately, with active institutions driving the investment side to pick up first. The publication of various administrative regulations will also improve the equity investment market system and promote the healthy and steady development of China's equity investment market.

2. Literature Review

Equity investment is mainly divided into public equity investment and private equity investment. Among them, private equity investment has been developing rapidly, and in recent years it has become the third largest financing market main body after bank bond financing and public equity financing, and occupies an important position in the international financial market [1]. Equity investment returns more, unlike bond investment, equity investors enjoy dividends from the growth of the value of the invested company, and if the company goes public, it will bring more value. In addition to this, Hu Qing pointed out that equity investment can promote the growth of investee companies [2, 3]. Li Nan et al. argued that while injecting capital into investee companies, private equity investment companies also provide them with advanced production technology, talents and professional equipment, improve the internal governance structure of investee companies, improve their development strategy system, promote the development and growth of the company, and promote its successful listing, which effectively alleviates the investee company's "difficult financing" problem, and also greatly reduces the "difficult financing" problem, and also greatly reduces the "difficult financing" problem. This effectively alleviates the problem of "financing difficulties" of investee companies and greatly promotes the vigorous development of small and medium-sized enterprises [4, 5]. Therefore, from this aspect, private equity investment not only provides equity for the investing company, but also provides value creation for the investee company, realizing a "win-win" [6].

At the same time, as a long-term investment, equity investment has high risks. These risks come not only from the internal operation of the investment company, but also from the external environment and other unforeseen changes. First of all, the most direct risk of the company's equity investment comes from the market risk. Fluctuations in market conditions, changes in the policy direction of the industry in which it operates, and changes in consumer demand can all cause greater or lesser fluctuations in the stock market, and the return or risk arises as the value of the investee company and its stock grows or declines [7]. Policy risk includes different policy changes such as geographic, monetary, and industry policies. For example, some jurisdictions may complicate the process of doing business, increase the number of governmental approval steps, increase taxes, and other more stringent review processes. All of these will indirectly limit the growth of making business and reduce profitability.

Wu Xiaolu found that if the investee company itself has risks, such as the company's internal governance level, management capacity, etc., then the operational risk superimposed on the market risk may bring greater losses to the equity investment company [8]. The emergence of this risk often implies the occurrence of problems related to the internal operation of the company such as mismanagement of the investee company or biased decisions of decision makers. For example, the investee company's lack of experience in staff organization and management cooperation leads to internal conflicts, which seriously affects the company's productivity. Such a situation may lead to unforeseen consequences such as failure to meet the expected revenue or a large number of employees resigning, thus preventing the investor from achieving the expected profit and incurring a certain amount of loss. If the investee company is an industry that requires a large amount of capital investment, then it will generate sunk costs, so that the investor can not recover the invested funds [9].

Secondly there are financial risks and legal risks. Zhang Kai believes that if the invested company has financial problems such as cash flow shortage, broken capital chain, high gearing, etc., then it will directly affect its stock price, and the equity investment company will face huge losses [10]. At the same time, illegal behavior, intellectual property infringement and other legal risks will also have a certain impact on the operation of the investee company and the interests of the investment company [11].

In addition to this, the problem of information asymmetry also exists in equity investment. Deng Yanhua et al. argued that due to the information asymmetry between the two sides of the equity investment, there is a demand and interest inconsistency between the investing company and the investee company [12]. Dou Yinyi similarly pointed out that if the equity investment company did not do due diligence before investment and neglected to analyze the real situation of the target company, then disputes will likely arise after the equity investment, and the investee company's performance will not be able to meet the expectations and get into trouble, which will bring endless losses to the equity investment company [3, 11].

Therefore, the company in the process of equity investment decision-making, need to consider and estimate its possible risks and losses, and improve the company's risk management measures, improve the risk prediction and response capabilities.

Third, the company's equity investment risk case study, a major important way of equity investment in China is the signing of betting agreement between two parties. The betting agreement is a form of option, an agreement between the investing company and the investee company based on the uncertainty of the future. The betting agreement can control the future performance of the investee company to a certain extent, safeguard the rights and interests of the investing company, reduce the loss when the expected results are not achieved, and also help to alleviate the problem of expensive financing of the investee company, prompting it to grow and expand rapidly. However, in reality, there are many betting agreements in the market that are difficult to be successfully honored, and both parties get into disputes, resulting in huge losses.

Shandong Hanlin was established in 2008, the company's main business is the use of microbial fermentation method engaged in the long carbon chain dibasic acid series products and downstream product development, production and sales. In order to obtain the company's development funds, Shandong Hanlin in 2012 listed as a betting target, in 2011 attracted 27 PE institutions invested 1.408 billion of capital surprise into the shares, including the well-known PE institutions Silicon Valley Paradise, ZTE's venture capital company ZTE Hutchison.

However, Shandong Hanlin failed to list in 2012. According to the betting agreement signed before, if the listing fails in 2012 in China's small and medium-sized board or GEM board, the shares should be repurchased. However, Shandong Hanlin was unable to repay, so in the first half of 2013, Lengshuan Capital started to sue Shandong Hanlin, and in 2014, Lengshuan Capital froze Shandong Hanlin's equity. By now, 27 PEs had no hope to exit the company, and the loss amounted to 1.4 billion dollars.

The listing failure of Shandong Hanlin was mainly due to the inaccurate positioning of the industry and market, and the investment company failed to fully investigate and analyze Shandong Hanlin's technological level, R&D capability and adaptability to changes in the industry and market before signing the betting agreement. Most of the investment companies in the betting agreement of Shandong Hanlin focused on entering into investment in the second half of 2011, while the subject of the betting was listed in 2012, which could be seen that the investment companies relaxed their due diligence, did not rigorously and scientifically assess the risks and benefits of Shandong Hanlin, and failed to accurately grasp the real situation within the company, which finally led to the failure of the betting agreement, resulting in huge property losses. In addition, Shandong Hanlin's strategic planning was problematic, pursuing short-term benefits, and this high-risk development strategy was likely to bring it greater risks. The investment company failed to predict and evaluate the management's business behavior of Shandong Hanlin, so there was a greater risk of breach of contract in the betting agreement, which ultimately put Shandong Hanlin and the investment company in trouble.

3. Risk Management in the Company's Equity Investment

3.1. Correctly Assess Its Own Ability

The company in the formal equity investment before, should be clear about their own investment direction, the target company and their own risk tolerance. The cash flow and gearing ratio of the investing company determines how much loss it can bear, and then select the corresponding target company based on the degree of loss. In addition, it is also necessary to continuously improve the investment company's own scientific and technological level, management capabilities, in order to improve the risk tolerance and the degree of loss bearing.

In addition, the company should adopt effective risk control policies, including loss control, risk avoidance, risk transfer and risk retention. First of all, loss control applies to companies that are not willing to give up their investment and are willing to face the risk. All it needs is to minimize the loss. It consists of two parts, in the first part of the stage of loss prevention, the company needs to take measures to deal with the possible risks first. In the second part, loss suppression, it means that the risk has already occurred and the company needs to minimize the extent of the loss. Secondly, risk avoidance is a very extreme form of risk control, which means that the company completely gives up taking risks, i.e. the probability of risky behavior becomes 0. It generally occurs when the company decides to give up its original plan after discovering that it cannot take risks. It also depends on the investment firm's attitude towards risk and the amount of capital available to deal with it. In addition, risk transfer refers to the transfer of risk from the firm to another person or firm, either contractually or non-contractually. Finally, risk retention refers to a company taking on risks autonomously with its own internal resources. It, along with insurance, is the main way of financing a company after it has faced a risk, and many developed countries have adopted this type of risk control. It differs from other risk policies in that it does not change the destructive power or probability of occurrence of the risk. Many companies have an internal risk fund that is used to deal with possible risks and thus achieve the purpose of self-insurance.

3.2. Conduct Comprehensive Due Diligence

The company should conduct investigation and analysis by checking the annual report of the target company, reasonably and scientifically assessing the operating leverage, equity leverage and other financial indicators of the target company, carefully checking whether there are financial loopholes and other financial problems in the target company, reviewing the authenticity and reasonableness of the data in its annual report and analyzing the profitability of the target company. At the same time, the company also needs to conduct interviews and investigations with the senior management of the target company, analyze the internal governance structure of the target company, check its corporate development strategy, and focus on the study of the target company's indebtedness. In addition, the

company should also strengthen its legal due diligence to analyze and assess whether there are potential legal risks in the target company. Legal risks are mainly reflected in the contract, and the investor needs to carefully review the contract to ensure that all contractual requirements are acceptable. This includes the transfer of equity. Some countries have laws that specify the requirements for the transfer of equity. For example, in China, shareholders of a limited liability company can transfer all or part of their shareholdings to each other, but they need to go through complex voting procedures. Therefore, the investor can make sure that the information of equity holding is accurate and risk-free to prevent legal entanglements in the future.

3.3. Strengthen Tracking and Management

After an equity investment is made, the investor company needs to track and manage the investment regularly in order to find out the shortcomings of the investee company and improve or stop the loss in time. The investment company should actively participate in the decision-making process of the investee company, scientifically supervise its operation, and timely evaluate the return on investment. In order to obtain higher rights and interests, the investment company should select more capable managers to enter into the investee company, assist the investee company to deal with relevant company matters and decisions, improve the original management system, strengthen the supervision of the original management system, divide the work among themselves, cooperate with each other, and minimize the possibility of risks in the future. Secondly, the investing company should provide more high-quality services to the investee company, such as the provision of advanced technology, equipment, etc., to help it improve its production level, improve the business environment, and promote the growth and development.

4. Conclusion

Equity investment, as a major important investment method in the capital market, provides equity for both parties to the investment at the same time, there is also the possibility of taking risks. Before formal equity investment, the company should clarify its own investment direction, target company and its own risk tolerance, and select the corresponding target company based on the ability to bear risks; the company should also conduct comprehensive due diligence, scientific analysis of the target company's profitability, and reasonably assess whether the target company has potential legal risks; after the equity investment, the investment company also needs to track and manage the investment on a regular basis to timely identify the deficiencies of the investee company and After the equity investment, the investment company also needs to track and manage the investment on a regular basis, so as to find out the deficiencies of the investee company and improve or stop loss in time. Driven by the overall favorable macroeconomic conditions, the main body of equity investment will further improve the risk management system and promote the healthy and sustainable development and growth of China's equity investment market.

Authors Contribution

All the authors contributed equally and their names were listed in alphabetical order.

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