

Research on Risk Management of Equity Pledge in Listed Companies: A Case Study of Guirenniao

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Abstract. In the present financial market, the financial needs of listed companies are expanding rapidly. Equity pledge, as a commonly used means of financing for listed companies, is becoming increasingly significant. As an emerging form of guarantee, equity pledge allows listed companies to pledge their own equity as collateral to obtain financing from external financial institutions. Equity pledge has many advantages, such as universality, fast financing speed, strong security, and effective risk diversification. However, equity pledge not only meets the financing needs of listed companies, but also brings corresponding risks to them. This paper selects the classic case of Guirenniao Co., Ltd. as the research object and adopts the literature analysis method to review relevant research on equity pledge both domestically and internationally. Based on the leverage cycle theory, PBC (Private Benefits of Control) theory, and asymmetric information theory, the article analyzes the risks associated with equity pledge and identifies excessive pledge by Guirenniao as an important factor contributing to the failure of company operation. Finally, based on the research findings, risk response measures are proposed from the main aspects of external information disclosure, internal supervision and control, enhancement of enterprise value, and dynamic monitoring of business operations. It aims to raise awareness among other listed companies and their stakeholders, prevent risks, effectively supervise the equity pledge behavior of listed companies, and ensure the sustainable development of equity pledge.

Keywords: Guirenniao; Equity pledge; Risk management.

1. Introduction

Equity pledge, as a common means of financing by pledging the company's own equity to other financial institutions, has become an option for many listed companies to attain fast and stable financing in the mature and standardized Chinese financial market. According to data from the Eastmoney Data Center, as of January 26, 2024, the total proportion of A-share pledges was 3.76%, with 2,427 pledging companies and 16,200 pledging transactions. The total number of pledged shares reached 355.011 billion, with a total market value of 2.57 trillion yuan, signifying a significant influence in the A-share market [1].

At present, both domestically and internationally, theoretical research on the risk of equity pledge has reached a relatively mature stage. Chen et al. argue that a high proportion of equity pledge can pose significant risks to enterprises and further worsen their operating conditions in the subsequent development process [2]. Ding et al. have analyzed the various motivations behind equity pledge of listed companies and the corresponding risks that may arise, using Oceanwide Holdings as a case study [3]. Mu et al. have explored the relationship between the proportion of Controlling Shareholder Equity Pledge (CSEQ) and inefficient investment, and they have discovered that improving internal control can effectively prevent excessive investment by enterprises [4]. Zhang et al. have conducted empirical research using data from Chinese A-share listed companies from 2011 to 2021. They found that the digital transformation of the financial industry has effectively alleviated adverse phenomena such as information asymmetry in equity pledge. Lastly, they have put forward reasonable suggestions to promote the digital transformation of corporate finance [5].

This paper first analyzes the theoretical foundation of equity pledge risks and subsequently examines the case of Guirenniao's equity pledge based on relevant theoretical frameworks. By considering various theoretical perspectives, it investigates the reasons for the failure of Guirenniao's

equity pledge and proposes risk management suggestions for equity pledge. Finally, a conclusion is drawn.

Pledging business is a high-risk financial activity that demands significant attention and the establishment of institutional norms to lay the groundwork for improving China's level of equity management. It also provides an important reference for enhancing China's financial risk prevention and control system.

The second part of this paper presents a summary of relevant theories on equity pledge risks of listed companies. The third part constitutes a case analysis of Guirenniao's equity pledge risks, and the final part offers a summary and enlightenment, outlining the research findings of the entire paper.

2. Related Theories on the Risk of Equity Pledge in Listed Companies

2.1. Theoretical Basis of Equity Pledge Risk

2.1.1. Leverage Cycle Theory

Minsky, H.P. introduced the leverage cycle theory, which highlights a strong connection between leverage cycles and economic crises. During an upward cycle, companies typically increase their leverage as a means of obtaining financing. Conversely, during a downward cycle, companies are compelled to bolster their collateral and reduce leverage ratios in order to ensure stability, thereby intensifying the pressures they face [6]. In a study conducted by Liu on equity pledge practices at Talent Television and Film, it was revealed that the company opted for equity pledge financing to repay its mounting debts, as a response to the expanding scale of its financial obligations. However, the excessive reliance on equity pledge rendered the company highly susceptible to the risks associated with potential declines in stock prices [7].

2.1.2. PBC Theory

Shleifer et al. put forward the PBC theory, positing that a significant concentration of equity ownership can result in major shareholders exerting excessive control. Even when equity is pledged, major shareholders can exploit their control over the company to pursue personal gains through related party guarantees, related party transactions, and other methods. Such actions encroach upon the interests of small and medium-sized shareholders as well as third-party financial institutions [8]. Preventing instances of equity misappropriation remains a highly salient concern in today's financial market.

2.1.3. Asymmetric Information Theory

Asymmetric information refers to a scenario in economic activities where participants possess varying levels of information, resulting in those with informational advantages gaining a superior position over those at a disadvantage. This ultimately leads to adverse selection phenomena [9]. Teoh et al. presented the asymmetric information theory in equity pledge. As pledgors, listed companies typically possess more informational advantages than pledgees. Certain listed companies employ tactics such as falsifying company profit data and concealing negative information to artificially inflate stock prices and secure higher returns on equity pledges [10]. This asymmetric information has significantly threatened the standardization and stability of the financial market while also harming the interests of other financial market participants.

3. Case Analysis of Guirenniao's Equity Pledge Risk

3.1. Current Situation of Guirenniao's Development

Guirenniao Co., Ltd. was established by Lin Tianfu in 2004, specializing in the shoe and apparel industry. Seizing the opportunities presented by the era, Guirenniao ventured into international brand OEM business, achieving remarkable success. Subsequently, the company rapidly expanded in the Chinese market utilizing various marketing approaches. By 2011, Guirenniao boasted 5067 stores

and successfully went public on the A-share market in 2014, with its stock price reaching its pinnacle in 2015. However, despite its efforts, Guirenniao failed to establish its own competitive advantage. Faced with challenges from competitors, it chose a strategy of diversified expansion, obtaining significant financing through equity pledges and acquiring multiple enterprises. Due to strategic mistakes and ineffective risk management, it eventually fell into a debt crisis and came close to delisting.

3.2. Equity Pledge of the Controlling Shareholder of Guirenniao

Guirenniao Co., Ltd. is an enterprise that is family-owned and operated. The primary shareholder in the beginning was Guirenniao Group, which maintained full control over the company for a significant period of time during its operations (Refer to Fig. 1).

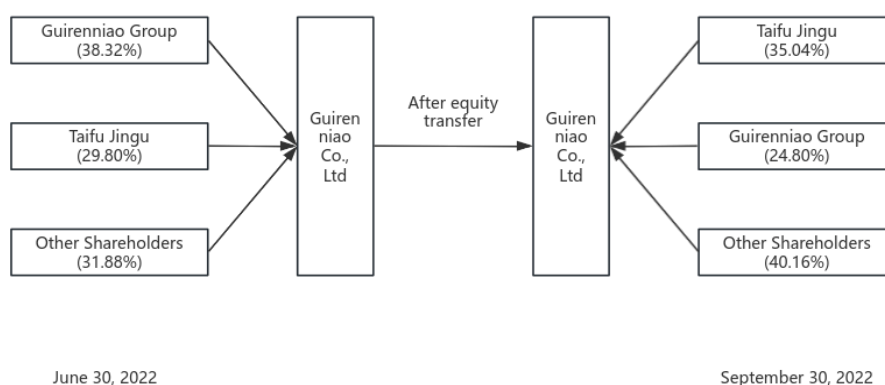


Fig 1. Transfer of equity of controlling shareholders of Guirenniao (Picture credit: Original)

3.3. Reasons for Guirenniao's Equity Pledge Risk

The reason why Guirenniao assumes the risk of equity pledge is attributed to the implementation of its diversified business strategy between 2014 and 2017. Within this time frame, Guirenniao sought to establish a comprehensive sports ecosystem by acquiring sports-related companies, thereby expanding its market presence and influence. In order to secure the necessary financing while retaining control over the company and transferring operational risks, Guirenniao resorted to a significant amount of equity pledge during this period.

3.4. Process of Guirenniao's Equity Pledge

By utilizing equity pledge as a financing tool, Guirenniao effectively alleviated its financial burden during the initial stages of diversification. However, the company encountered multiple setbacks in its subsequent diversification process. According to Guirenniao's annual report, the company embarked on its diversification path after 2015. Nonetheless, following the initiation of diversification, Guirenniao experienced a continuous decline in net profit attributable to shareholders. In 2015, the net profit reached a peak of RMB 279,423,534.00, which gradually decreased to RMB 89,025,962.00 in 2017. Furthermore, the company recorded negative net profits attributable to shareholders for an extended period from 2018 onwards. These business figures demonstrate that Guirenniao's diversified operations failed to generate synergistic effects or establish core competitiveness. Instead, it consumed substantial funds and led to increased corporate bloating (Refer to Table 1).

Table 1. Historical Business Status of Guirenniao

Year	Revenue (RMB)	Net Profit Attributable to Shareholders (RMB)	Net Profit Attributable to Shareholders after Deductions (RMB)
2013	2,405,921,409.30	423,489,914.47	390,003,227.28
2014	1,919,650,412.10	312,241,847.24	277,363,546.51
2015	1,969,022,044.41	331,836,966.49	279,423,534.80
2016	2,279,020,179.02	292,659,802.91	255,935,719.62
2017	3,252,075,597.67	157,307,658.42	89,025,962.49
2018	2,812,460,499.91	-685,879,243.20	-646,559,422.30
2019	1,581,478,301.94	-1,095,826,205.15	-1,116,918,688.01
2020	1,188,179,186.10	-382,207,905.30	-410,152,345.00
2021	1,419,055,803.58	360,633,684.63	89,881,232.32
2022	2,108,124,656.07	-9,413,692.05	69,368,342.72

Guirenniao's failure to establish a robust risk management mechanism and contingency plans for diversified development has resulted in its inability to effectively respond to difficulties encountered in diversified operations, leading to a sharp decline in the company's stock price. According to the leverage cycle theory, the rapid decrease in Guirenniao's stock price has caused a significant increase in its leverage ratio. To mitigate this and ensure the company's normal operations, Guirenniao has opted to add collateral. However, during this process, Guirenniao has exhibited significant deficiencies in managing the risks associated with equity pledges, resulting in a path-dependent reliance on such pledges. This has led to a continuous increase in the pledge ratio (Refer to Fig. 2). Ultimately, the pledge ratio has reached a dangerous level of 99.02%, signifying the complete failure of Guirenniao's diversification efforts in the sports sector.

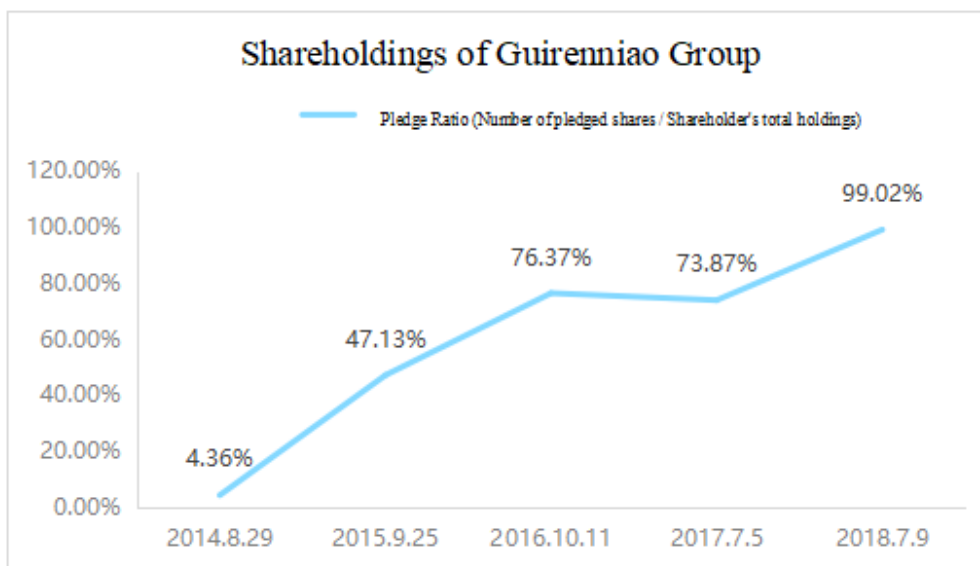


Fig 2. Changes in Pledge Ratio of Guirenniao Group's Shareholding

Due to a high proportion of equity pledged by Guirenniao Group, coupled with under-performance in its diversified business strategy and the inability to repay financing funds, the shareholding pledge ratio continued to increase, significantly exacerbating the company's financial burden. This resulted in a continuous decline in the company's stock price, eventually leading it to the brink of delisting. In 2022, when the maturity of Guirenniao's equity pledge posed a repayment dilemma, former chairman Lin Tianfu lost control of the company, and Taifu Jingu became the new major shareholder of Guirenniao. Upon assuming control of the company, the new chairman Li Zhihua shifted Guirenniao's business focus to the grain industry while gradually phasing out its involvement in the shoe and

clothing market. (Refer to Fig 1.) Guirenniao uses its own experience to highlight the immense harm caused by neglecting equity pledge risk management.

3.5. Risk of Equity Pledge of Guirenniao

Based on the PBC theory, Guirenniao is categorized as a family business, with the Guirenniao Group holding more than 75% of the company's shares for an extended period. This concentration of power among major shareholders poses a risk of their encroachment on the interests of small and medium-sized shareholders. Leveraging their control rights, Guirenniao offers long-term guarantees to JZX Sports, with Guirenniao's director and deputy general manager also serving as directors of JZX Sports. This cross-guarantee constitutes a related-party guarantee, which significantly infringes upon the legitimate rights and interests of other participants in the financial market.

According to the asymmetric information theory, Guirenniao faces challenges in disclosing information related to equity pledges. As a publicly listed company, Guirenniao fails to disclose the specific use of funds raised through financing in its public announcements, creating a risk of information asymmetry.

Additionally, the inability to repay the equity pledge upon maturity increases the risk of control transfer, ultimately resulting in the Guirenniao Group losing control over the company. The accumulation of negative information following equity pledges has led to a decline in the company's value, further exacerbating the situation for Guirenniao.

4. Countermeasures for the Risk of Equity Pledge in Guirenniao

4.1. Enhancing Information Transparency and Restricting Pledge Behavior

By establishing a company disclosure system, we can effectively improve information transparency. Pledge plans should be publicly disclosed, and information such as the pledger, quantity, proportion, price, term, and purpose should be timely and fully disclosed. Pledge behaviors that harm the interests of small and medium-sized shareholders should be regulated. Reasonable risk assessment should also be conducted within the company to achieve pledge risk control, such as setting pledge limits based on risk assessment to restrict the scale of pledge and prevent risk overflow.

4.2. Optimizing the Corporate Governance System and Strengthening Internal Controls

Establishing a scientific and reasonable corporate governance system and strengthening the internal risk control system will enable early detection and control of various potential risks. The equity structure should be reasonably allocated to balance the rights of major shareholders and small and medium-sized shareholders, ensuring that the rights and responsibilities are aligned. This will enhance the effectiveness of board supervision and decision-making.

4.3. Enhancing Business Performance and Scientifically Managing Funds

Implementing an effective incentive system for business performance and improving the reward and punishment mechanism will encourage better performance. Scientific management of financing funds should be implemented to prevent unauthorized misappropriation of funds by shareholders. Additionally, conducting fund forecasting and analysis will help prevent funding gaps and difficulties in fund turnover, ensuring efficient utilization and return of funds for the company. By establishing a comprehensive fund risk management mechanism, various internal and external fund risks can be timely detected, evaluated, controlled, and responded to.

4.4. Continuously Monitoring Business Dynamics and Preventing Risks in Advance

Strengthening the supervision system and ensuring the effectiveness of the supervisory board and independent directors will limit the expansion of the rights of major shareholders. The regulatory structure of the company should be optimized, with strict scrutiny of the independence of independent

directors, establishment of ethical standards, enhanced information communication with small and medium-sized shareholders, and expanded regulatory channels. Independent directors should be supervised to ensure they fulfill their responsibilities, and dereliction of duty should be punished accordingly.

5. Conclusion

This paper conducts an analysis on the case of equity pledge risk in Guirenniao. By summarizing relevant theories through literature review, this paper analyzes the risk of equity pledge from the perspectives of leverage cycle theory, PBC theory, and asymmetric information theory. Simultaneously, the situation, motives, processes, and risks associated with Guirenniao's equity pledge are analyzed and summarized. Finally, it drawn an conclusion that poor operational management of listed companies, negligence in risk management, and excessive pledging can result in turbulence and crises such as equity transfer. However, it is emphasized that strict and prudent risk management practices can effectively mitigate the risks associated with equity pledge. Furthermore, this paper identifies the sources of risks in different aspects of equity pledge and provides recommendations for listed companies to effectively avoid these risks. These recommendations include enhancing transparency, strengthening internal supervision, and imposing strict limitations on collateral. It is important to note that due to constraints in space, empirical analysis on various risk factors was not conducted in this paper. Hence, it is suggested that a multi-factor model be established to better measure these risk factors.

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