Role and Impact of Private Equity in Mergers and Acquisitions of Publicly Listed Companies

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Abstract. This article discusses the role and impact of private equity funds in the mergers and acquisitions of listed companies. It introduces the historical development of private equity funds, the domestic and international M&A background, as well as the research purpose and significance. The section exploring the role of private equity in the mergers and acquisitions of listed companies discusses the methods of private equity intervention and financial support, along with the relationships and decision-making processes involving other investors. Additionally, the article discusses the impact of M&A funds on market activity and evaluates market price fluctuations. The article delves into the discussion and prevention of risks, covering positive effects and collaborative advantages, regulatory challenges in new models, negative effects and risks, as well as challenges and cooling trends in the models. Future regulatory efforts should focus on strengthening the scrutiny and disclosure of related-party transactions, consolidated financial statements, and announcement disclosures.

Keywords: PE, Merger and acquisition funds, Listed companies, PE + listed company mode.

1. Introduction

1.1. Background

1.1.1 The historical development and organizational forms of Private Equity (PE)

Private Equity (PE) originated in the United States in 1976 and has evolved over 30 years to become a significant financing avenue, ranking only behind bank loans and IPOs. Its role in the mergers and acquisitions market has become increasingly prominent, with 2022 marking a year where private equity transactions ranked second in terms of activity. In China, the split-share reform provided conditions for the rise of private equity funds while simplifying the acquisition process among listed companies. According to data from 2015 to 2023, the domestic industrial merger and acquisition fund market maintained a compound growth rate of around 8% annually. Despite a goodwill impairment default event in 2018, the market size slightly increased in 2019, reaching a scale of 180 billion. In 2023, merger activities slowed down, with listed companies' participation in completed mergers increasing by 26.85%. Private equity funds exhibit diverse organizational forms, including corporate, contractual, virtual, composite, limited partnership, and trust structures, each with distinct characteristics and applicable scenarios.

1.1.2 The background of foreign Private Equity (PE) participation in mergers and acquisitions of listed companies

In Western countries, Private Equity (PE) and listed companies typically collaborate in several ways: Leveraged Buyouts (LBOs) involve acquiring the equity of a listed company to convert it into a private company, often utilizing leveraged financing [1]. Equity Investments allow private equity firms to purchase partial ownership shares for future growth without controlling the target company; Restructuring and Integration aim to improve the company's condition and reduce costs, with private equity firms providing funds and management expertise; Public Market Investments involve purchasing stocks as investments without managerial intervention; Special Purpose Acquisition Companies (SPACs) are special public companies, and private equity firms can acquire target companies by establishing or investing in SPACs [2].

1.1.3 The emergence of domestic "PE + listed company" merger and acquisition funds as a capital operation model

In China, merger and acquisition funds are divided into two types: those supporting the restructuring and acquisition of listed companies and those acquiring control of listed companies [3]. Among them, the "PE + listed company" cooperation model originated in 2011 [4] as a new type of investment and financing method, which can reduce costs and risks. The years 2013 and 2014 were referred to as China's "merger years" and "active merger years" [5]. With China's economy entering the "new normal," merger and acquisition funds have flourished. Collaboration between listed companies and private equity investment management institutions has become mainstream.

1.2. Importance of Private Equity (PE) in Mergers and Acquisitions of Listed Companies

1.2.1 Analyzing the performance and risks of this capital operation model

The role of private equity (PE) in mergers and acquisitions has become increasingly important. Private equity firms can easily access significant amounts of capital, providing support for large-scale transactions. Over the past decade, U.S. private equity firms have invested approximately $10.7 trillion. Additionally, these firms possess specialized knowledge and operate with high efficiency, enabling in-depth industry and competitive research before making tender offers and ensuring the success of transactions. These factors establish private equity as a key player in the mergers and acquisitions landscape. In current academic research, only a few scholars suggest that mergers and acquisitions may potentially damage company value, with the majority holding different opinions [6-8]. Empirical studies [9] confirm that acquisition funds contribute to value creation for themselves, the acquired companies, and the acquiring companies. The collaborative model between PE and listed companies in mergers and acquisitions demonstrates clear advantages in transactions [10]. This model helps reduce investment risk by leveraging the strengths of both listed companies and PE firms during project screening and due diligence, minimizing unnecessary work and lowering investment risk. Furthermore, this model aids in determining exit paths in advance. Through collaboration with listed companies, acquisition funds can secure exit channels through equity repurchases or secondary mergers, providing a reliable exit strategy. Lastly, the model contributes to enhancing the value of the acquired assets. Private equity firms gain from the benefits of asset restructuring upon exit, leveraging industry knowledge and realizing the profits of asset restructuring.

1.2.2 Explore its impact on enterprise development

Through mergers and acquisitions, companies can optimize and integrate resources, thereby saving costs and improving efficiency. Mergers enable companies to achieve diversified development in revenue sources, product and service lines, and regional markets, thereby reducing operational risks. Additionally, PE participation in mergers and acquisitions transactions can bring diverse financial-based social networks to listed companies [11], and mergers also provide opportunities for companies to acquire new technologies and talents, enhancing competitiveness and innovation capabilities. Furthermore, merged companies typically achieve better financial management and have the opportunity to maximize tax benefits. Finally, through mergers and acquisitions, companies can rapidly expand into new markets, establish new customer bases, and increase sales opportunities and revenue sources, thereby driving rapid enterprise development.

2. Roles Played by PE in Mergers and Acquisitions of Listed Companies

2.1. PE Intervention Methods and Financial Support

2.1.1 Direct investment and controlling investment

Private equity funds play a significant role in mergers and acquisitions of listed companies, with direct investment and controlling investment being among their common intervention methods. Through direct investment, private equity funds can directly purchase shares of listed companies, thereby acquiring a certain percentage of equity. Controlling investment, on the other hand, involves private equity funds acquiring control over a listed company by purchasing a large number of shares or using other means, thus exerting influence over the company's operations and management.

2.1.2 Equity acquisition and debt-to-equity conversion

Private equity funds play a significant role in the mergers and acquisitions of listed companies, with direct investment and controlling investment being among their common intervention methods. Through direct investment, private equity funds can directly purchase shares of listed companies, thereby acquiring a certain percentage of equity. Controlling investment involves private equity funds acquiring control over a listed company by purchasing a large number of shares or using other means, thereby influencing the company's operations and management.

2.1.3 Capital injection and financing arrangements with structural optimization

Private equity funds also play a role in capital injection, financing arrangements, and structural optimization in the mergers and acquisitions of listed companies. Capital injection involves private equity funds injecting funds into listed companies to assist them in conducting M&A activities. Financing arrangements entail private equity funds assisting listed companies in arranging financing channels to complete M&A transactions. Structural optimization involves private equity funds optimizing the financial structure and business model of listed companies to enhance their competitiveness and profitability.

2.2. Relationships with Other Investors and Decision-Making Processes

2.2.1 Cooperation and Competition, Control Rights and Shared Interests

In their relationships with other investors, private equity funds can act as both collaborators and competitors. Collaborative relationships between private equity funds and other investors can bring benefits such as resource sharing and risk mitigation, but they may also involve issues of profit distribution and control rights disputes. Conversely, competitive relationships between private equity funds and other investors may lead to resource wastage and market turmoil.

2.2.2 Target selection and strategic planning, negotiation, due diligence, and contract

Private equity funds need to engage in target selection, formulate and implement corresponding strategies, negotiate, conduct due diligence, and ultimately reach contracts during the mergers and acquisitions (M&A) process with listed companies. During the target selection phase, private equity funds must conduct a thorough analysis and evaluation of potential acquisition targets to ensure that the chosen targets align with their investment strategy and objectives. In the strategic planning phase, private equity funds need to determine and implement appropriate M&A strategies to ensure the smooth progress of the acquisition activities.

The negotiation, due diligence, and contract conclusion phase involves private equity funds engaging in specific negotiations and communications with listed companies and other relevant parties to determine transaction details and ultimately reach consensus contracts.

2.3. "PE + Listed Company" M&A Fund Operation Mode

As shown in Table 1, the "Listed Company + PE" type of M&A fund operates by focusing on acquiring enterprises, gaining control, and achieving high returns. It aligns with the strategic goals of listed companies and national policies [12], providing funds for overseas acquisitions [13]. Collaboration between industrial capital and PE offers financial support and resources, addressing fundraising challenges and reducing risks [14]. The partnership between listed companies and PE institutions to establish funds can mainly be classified into LP (Limited Partner) and GP (General Partner) models. In the LP model, listed companies purely participate as investors, while the GP model can be further divided into three types: listed companies acting as sole GP/manager, joint GP/manager, or dual GP. The wealth effect is influenced by various factors, including information disclosure and market conditions. The operation of such M&A funds in China resembles that of other private equity funds, encompassing fundraising, investment, management, and exit stages [15]. Current research primarily focuses on overseas acquisitions and industrial chain integration. Therefore, further research is needed to explore the value creation of "Listed Company + PE" type M&A funds in depth.

Table 1. The differences between "PE + Listed Company" type M&A funds and traditional M&A funds

	"PE + Listed Company" Type M&A Fund	PE-backed M&A Funds, Brokerage-backed M&A Funds
Investors	Qualified investors, more widespread	Most mature institutional investors
Project Requirements	Related to upstream and downstream industries of listed companies Companies	More extensive, but not limited to a specific industry
Acquisition Methods	Controlling type	Controlling type, participating type, and various other investment methods
Exit Channels	Selling to listed companies	IPO, selling, etc.

3. The Impact of PE Participation in the Mergers and Acquisitions

3.1. The Stimulation of Market Activity

Private equity funds play a crucial role in the mergers and acquisitions of listed companies, often driving market activity. Through the intervention of private equity funds, mergers and acquisitions among listed companies are encouraged, thus increasing market trading volume and liquidity. The investment activities of private equity funds often attract market attention, drawing more investors to participate and thereby boosting market activity. Additionally, the M&A activities of private equity funds can inspire other companies to engage in mergers or acquisitions, further driving market development and activity.

3.2. Assessment of Market Price Fluctuations

The activities of private equity funds in the mergers and acquisitions of listed companies often cause fluctuations in trading market prices, making it essential to assess their impact. Before and after the intervention of private equity funds in M&A activities, market prices often fluctuate, which may influence the investment decisions of market participants. Therefore, evaluating the impact of private equity fund activities in the mergers and acquisitions of listed companies on the fluctuation of trading market prices helps investors better understand the operational patterns of the market, enabling them to formulate more effective investment strategies.

4. Prevention of the Risks Associated with PE + Listed Company Mode

4.1. Discussion on the Risks of the "PE + Listed Company" Collaboration Model

PE participation in the acquisition of listed companies contributes to industrial integration and value enhancement. However, research indicates that this model may hinder industrial diversification [4], despite addressing the challenge of project searching and increasing risks. Investment directions are divided into two categories: related acquisitions and diversified acquisitions, which help improve corporate management capabilities and research strength, promoting the enhancement of industrial professionalism.

4.2. Positive Effects and Collaborative Advantages

The positive effects of collaboration between listed companies and private equity (PE) include enhancing the capability for industrial mergers and acquisitions, promoting industry concentration and upgrading, as well as guiding social capital to support economic development and structural adjustments. Through the provision of professional merger and acquisition services, this collaboration reduces cash flow pressure, promotes industry integration and upstream/downstream extensions, and helps enhance corporate competitiveness and optimize economic structure.

4.3. Regulatory Challenges of the New Model

The "PE + Listed Company" M&A fund model is relatively new in China [16], and regulatory authorities have not yet timely issued clear accounting treatment standards, leading to significant discretion in financial affairs. This cooperation model has sparked some controversies, such as how to measure the fair value of M&A funds and recognize investment returns.

4.4. Negative Effects and Risks

However, the cooperation between listed companies and PE also entails some negative effects, including the disruption of core business focus and investment, the proliferation of market manipulation risks, and the potential for insider trading hazards. Some PE entities may prioritize short-term gains, affecting the long-term development plans of enterprises, while certain collaborative activities may trigger issues such as market manipulation and insider trading, posing risks and uncertainties to companies and investors.

4.5. Challenges and Trends of the "PE + Listed Company" M&A Fund Model in China

Between 2014 and 2016, the "PE + Listed Company" model enjoyed a period of popularity in China. However, in recent years, there has been a noticeable cooling trend. Difficulties in fundraising, improper asset selection, conflicting interests, and regulatory policy constraints are the main reasons. Regulatory authorities have introduced stringent regulations that have increased the difficulty of listed company acquisitions. As a result, the "PE + Listed Company" model faces numerous challenges and may no longer be as popular as it once was.

5. Conclusion

China's economic situation is similar to that of the United States in the 1970s, with numerous small and medium-sized enterprises competing across industries. However, China has yet to improve its professional management team and mature merger and acquisition market. Therefore, the popularity of the "PE + Listed Company" model in China is inevitable. Over the past few years, this model has been continuously improving, from establishing M&A funds to signing cooperation agreements with listed companies, with the depth and breadth of collaboration constantly strengthening. Despite facing manipulation risks, regulatory authorities have issued relevant guidelines to standardize operations and have adopted an encouraging attitude. In recent years, this model has encountered challenges such as fundraising, asset matching, conflicting interests, and regulatory restrictions. It requires more emphasis on selecting M&A targets, investment logic, and fund diversification. Strengthening supervision and policy guidance is crucial to ensure the legality and compliance of cooperation between listed companies and private equity (PE) institutions, promote genuine industrial mergers and acquisitions, and avoid "market value management" acquisitions disrupting market order. The rise of this model reflects supply-side reforms and helps stimulate market vitality, reduce search costs, efficiently integrate upstream and downstream industries, improve resource allocation, and promote the combination of financial capital and industrial capital. However, challenges such as regulatory restrictions and fundraising difficulties still exist. It should be considered to strengthen supervision in areas such as related-party transaction review and disclosure, consolidated financial statements, and announcement disclosure to ensure the legality and compliance of cooperation, achieve the sustainability of long-term development for both parties and ensure the effectiveness of cooperation.

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