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Research on Financial Risk Prevention in Corporate Mergers and Acquisitions

-- A Case Study of X Company Acquiring Y Company

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Abstract: Over the past 40 years since the reform and opening up, enterprises have gone through a series of initiatives such as expanding business autonomy, contracting business responsibility system, establishing modern enterprise system, and implementing the action plan of reforming and improving quality, etc. At the present stage of development, the expansion of reproduction by endogenous accumulation alone can no longer adapt to the needs of the rapid growth of the enterprise and the competition in both international and domestic markets. Therefore, through mergers and acquisitions and other episodic expansion of reproduction, is an effective way to achieve low-cost expansion of enterprises and embark on a benign development track. In order to enhance the understanding of the financial risk of M&A, this paper, based on previous theoretical research results, combines relevant theories and methods, takes X enterprise's M&A of Y enterprise as a case study, analyses the financial risk involved, and puts forward the suggestions for controlling and preventing the financial risk.

Keywords: Corporate Mergers and Acquisitions; Financial Risk; Risk Prevention.

1. Introduction

After China's accession to the WTO, the economy shifted from a planned economy to a market economy, experiencing rapid development, and intensifying competition among enterprises. Many companies accumulated assets, resources, and wealth by focusing on their core businesses. However, facing the century's changes and the economic downturn in the post-pandemic era, internal accumulation alone is insufficient to adapt to the rapidly changing economic situation. Companies need to rapidly expand their scale and enhance competitiveness through mergers and acquisitions (M&A). M&A is a complex financing activity, and every step may bring risks. Careless handling of these risks can lead to M&A failures.

In the M&A process, particular attention should be given to the prevention and control of financial risks. Thoroughly researching and analyzing the causes of these risks and their corresponding strategies is crucial to increase the likelihood of M&A success. Financial risks may occur at various stages of M&A, making them the core focus and directly impacting the success of M&A projects. Neglecting financial risks may lead to financial crises for the acquiring company and even result in M&A failure. Therefore, studying financial risks in corporate M&A is of great significance for promoting the prosperous development of such activities and avoiding financial risks during the M&A process.

2. Current Research Status

Regarding the causes of financial risks in M&A, Yuan Yue (2020) proposed that companies mostly expand their scale and undergo transformation and development through M&A activities, with improper decision-making being a major cause of financial risks [1]. Wang Hao (2013) pointed out that one of the core reasons for causing financial risks in M&A is the asymmetry of information between the acquiring and target companies, making it difficult to evaluate the target company and leading to uncertain investment returns after the acquisition [2]. Liu Chang (2019), after studying integration risks, proposed an enterprise merger and resource integration model based on strategic cost motives and value chain theory. The paper discussed issues that need attention in the integration process after corporate M&A, including strategic positioning, organizational structure, and business processes [3]. Liu Wenjiao (2019) believes that issues such as M&A financing structure, costs, and duration are important obstacles to the development of corporate M&A [4].

Concerning the analysis of financial risk in M&A, Xu Jing et al. (2019) analyzed cases of M&A in network companies and derived different integration methods from aspects such as corporate culture, strategic development, and financial management systems [5]. Zhang Xiaoyu et al. (2017) quantified and classified risks, providing references for the successful implementation of M&A after processing risks in various aspects [6]. Guo Yixin (2019) suggested that foreign scholars mainly start from the characteristics of financial risks generated at different stages of M&A, while Chinese scholars have not combined the entire M&A process. The research on financial risks in M&A in China still remains at a single level of financial risk [7].

As for the control of financial risks in M&A, Shen Jing (2015) pointed out that strengthening financial monitoring is an important link after corporate mergers [8]. Liu Bingru et al. (2016) believe that a company's future healthy development depends on whether its financial risk management system is sound and standardized [9]. Wei Mingzhi (2011) suggested that due to asymmetric information, the risk of corporate mergers and reorganization is increased, and in severe cases, it may lead to the failure of M&A activities [10]. He Lili (2017), based on the specific practical experience of low success rates in cross-border M&A transactions by Chinese multinational enterprises, proposed that China's financial risk control in cross-border M&A transactions is inadequate [11].

3. Case Analysis

3.1. Acquiring Company - X Corporation

X Corporation was established in February 2008 with the approval of the provincial government. As of December 31, 2022, it had a registered capital of 6.4 billion yuan, total assets of 46.421 billion yuan, and generated main operating revenue of 13 billion yuan. The company, with 10,717 employees, focuses on core businesses such as biopharmaceuticals, industrial parks, and the information industry. It aims to become a leading enterprise in China's information technology industry, a leading enterprise in international industrial parks, and a top enterprise in strategic emerging industries such as high-end equipment manufacturing. X Corporation currently owns 4,000 acres of land and 270,000 square meters of real estate assets.

3.2. Target Company - Y Corporation

Y Corporation has been dedicated to the supply chain services business for many years. Starting in 2016, it entered the field of supply chain financial technology and collaborated with IBM China Research Institute to develop a blockchain platform, which was among the first in China to provide blockchain technology for supply chain financial applications. Y Corporation has made significant breakthroughs in technology areas such as the Internet of Things and has expanded its business from supply chain trade to commercial factoring and asset securitization services. The company has formed an integrated service system for supply chain finance. By the end of 2021, Y Corporation's blockchain platform had settled transactions totaling 154.8 billion yuan, with funds already deployed online reaching 16.5 billion yuan.

3.3. Analysis of Merger Motivation

Firstly, the merger allows for the synergy between the information industry sector and the Internet blockchain business, leveraging the strengths of both companies to promote business integration and further strengthen industrial capabilities. Secondly, Y Corporation's development strategy of "Internet + blockchain + supply chain finance" provides X Corporation with new business growth points, expanding its industrial layout. Additionally, Y Corporation's leading position in blockchain technology enables X Corporation to participate in the digital currency field, enhancing its voice in the emerging digital economy. Finally, through Y Corporation's supply chain finance business, X Corporation can attract more small and medium-sized enterprises to its industrial parks, thereby promoting industrial development. This acquisition brings both opportunities and challenges to X Corporation, representing a proactive strategic move.

3.4. Analysis of Merger Results

After becoming the controlling shareholder, X Corporation provided loans of nearly 700 million yuan to Y Corporation through shareholder loans to address historical issues such as Y Corporation's liquidity problems. However, these efforts proved futile, and X Corporation's group's investment of 4.7758 billion yuan in Y Corporation ultimately yielded no returns. The provincial state-owned assets incurred approximately 10 billion yuan in losses during the acquisition of Y Corporation, making it the single largest case of state-owned asset loss in M&A projects, causing significant national asset losses.

4. Risk Identification

4.1. Valuation Risk Identification

Improper Valuation Method Selection: X Corporation Group used the Price-to-Earnings Ratio (P/E ratio) method for the valuation of Y Corporation. However, Y Corporation had sustained negative net profits for four consecutive years, leading to a severe overvaluation. Financial Information Asymmetry Risk: Significant differences existed between the main businesses of X Corporation Group and Y Corporation, causing further expansion of information asymmetry risk during the valuation process. Valuation Premium Risk: Despite X Corporation Group contributing 40.758 billion yuan, the valuation appeared significantly overestimated relative to Y Corporation's net assets of 7.966 billion yuan as of the end of 2019.

4.2. Financing Risk Identification

Inappropriate Timing of Financing: X Corporation Group conducted financing in the second half of 2019 amid an overall downturn in the blockchain industry's investment climate, possibly indicating an ill-timed decision. Unreasonable Financing Structure: The distribution of ownership in X Corporation was deemed unreasonable, resulting in a lack of effective firewall isolation measures when risks arose in the project. Inappropriate Financing Method: The financing for this transaction primarily employed internal financing. However, for a rapidly expanding entity like X Corporation Group, sole reliance on internal financing might increase financial pressure and impact future investment and financing activities.

4.3. Payment Risk Identification

Cash Flow Risk: X Corporation Group paid a significant amount, accounting for 55.94% of the year's cash and cash equivalents, which may exert pressure on liquidity.

Inappropriate Payment Method Risk: The entire payment for this acquisition by X Corporation was made in cash, amounting to a substantial 3.894 billion yuan. With limited monetary funds and retained earnings, this payment constituted 64.61% of X Corporation's cash funds for the year of the acquisition. The situation was exacerbated in 2021, with a decrease of 258 million yuan in cash funds compared to 2020, and a drastic decline in net profit, leading to financial strain and long-term financial pressure for the company.

4.4. Integration Risk Identification

Financial Risks Arising from Business Integration: After the acquisition, X Corporation's sales net profit margin, total asset net profit margin, and equity net profit margin all experienced a sharp decline in 2021, disrupting the previously favorable development trend of Yunnan Industrial Investment Group. This increase in uncertainty also added to the instability of profit capabilities. Financial Risks Arising from Operational Model Integration: The main businesses of X Corporation and Y Corporation were in completely different industries, with entirely distinct operating, profit, and business models. The integration difficulty was amplified by one being a provincial state-owned enterprise following relevant management systems for state-owned assets, and the other being a private listed company. This stark difference in operational models presented significant challenges in integration.

5. Risk Prevention Recommendations

5.1. Valuation Risk Prevention Recommendations

Conduct Thorough Due Diligence: During the M&A process, conduct comprehensive and meticulous due diligence to ensure obtaining comprehensive information about the target company. This helps avoid the use of improper valuation methods that could lead to overvaluation risks. Engage Third-Party Professional Organizations: For larger-scale M&A projects, consider hiring third-party professional organizations to assist in the M&A process. These organizations can provide a multi-faceted evaluation of the target company and offer professional M&A advice. Use Reasonable Valuation Methods: Establish an appropriate evaluation system based on the industry and company characteristics. Consider multiple indicators, quantify non-financial indicators, and integrate them to provide an objective and accurate valuation of the target company.

5.2. Financing Risk Prevention Recommendations

Optimize Capital Structure: Optimize the company's capital structure by integrating self-owned funds and financing funds appropriately. Ensure the normal development of existing business while supporting M&A activities, thereby enhancing the overall economic value of the enterprise. Diversify Financing Channels: In addition to internal financing, explore external financing channels. Use various methods such as bank loans, debt financing, and equity financing flexibly to ensure that financing meets the needs of M&A. Develop Financing Plans: Based on the actual situation of the enterprise, develop a diversified financing structure. Flexibly use different financing methods to provide solid financial support for the implementation of M&A.

5.3. Payment Risk Prevention Recommendations

Use Diverse Payment Methods: Depending on the characteristics of the M&A project, flexibly choose different payment methods such as cash plus debt or cash plus equity to reduce risks during the payment process. Select Appropriate Payment Timing: Analyze and choose the optimal payment timing carefully, considering the actual situation of the enterprise. Ensure the stable progress of the payment process to maintain the financial stability of the company. Determine the Maximum Cash Payment Amount: Conduct a careful calculation of cash flow to ensure that after paying the M&A funds, the company can still maintain normal operations and carry out financial activities such as debt repayment.

5.4. Integration Risk Prevention Recommendations

Enhance Business and Financial Integration Control: Strengthen control over business and financial integration after the M&A. Implement reasonable integration measures to improve overall operational efficiency and reduce risks. Integrate Existing Assets and Liabilities: Optimize the integration and allocation of existing assets and liabilities of the acquired company. This aims to enhance the operational efficiency and financial condition of the company post-M&A.

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