



Analysis of the Financial Risk of Mergers and Acquisitions in Chinese Shipbuilding Corporations and the Precautionary Measures

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Abstract

As can be seen from the overall development situation of the shipbuilding industry, the shipbuilding industry develops slowly due to the impact of the international economy. The development of the shipbuilding industry has encountered bottlenecks, namely sharply decreasing whole market demands of shipbuilding, and excess production capacity. Facing with the problems such as small production scale, inadequate order quantity, and scanty working capital funds, a group of small and medium sized shipbuilding enterprises tend to merger in a large scale so as to expand strength, improve competitiveness, promote cluster development of advantaged resources. However, various research statistics have shown that the financial risk of mergers has caused many failure cases. Therefore, the research on the financial risk of mergers and acquisitions of shipbuilding enterprises contributes to taking effective measures to prevent risk and improving the success rate of shipbuilding enterprises mergers.

Key words: Mergers and acquisitions; Financial risk; Shipbuilding enterprises in mergers and acquisitions; Target shipping enterprises

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INTRODUCTION

After the financial crisis, the shipping market remained weak, the production capacity of shipbuilding enterprises were surplus, and the profit margins of the large state-owned shipbuilding enterprises reduced significantly. Based on the relevant statistical data, it shows that over one-third of small and medium sized shipbuilding enterprises are difficult to obtain orders due to the lack of technical strength and scale economy, reduced hand-held orders make the production and management get into trouble. Since 2011, there are many shipping enterprises going bankrupt, such as Ningbo Blue Sky Shipbuilding Group and Nantong HuiGang shipping Industry. Meanwhile, there are issues such as low degree of industrial concentration, low productivity, weak market strain capacity, lack of world-class shipping enterprises and world-renowned brands existing in Chinese ship industry. All these reveal that the Chinese ship industry is facing serious difficulties. Under such market backdrop, mergers and acquisitions have become an important means for these enterprises to reverse. However, there are certain financial risks in mergers, and they will bring some hidden troubles for the development of both companies after merger.

1. M&A CHARACTERISTICS OF CHINESE SHIPBUILDING ENTERPRISES

1.1 Definition of Merger Concept

The enterprise merger refers to that, under the conditions of market economy and legal system, two or more enterprise merger into one for common interests by signing a market contract. It can improve enterprises' management efficiency, optimize enterprises' assets disposition, and modernize increased assets.

1.2 Development Dilemma of Shipbuilding Enterprises

1.2.1 Low Industry Concentration and Low Productivity

According to the following Table 1, the shipbuilding completion continues to drop in recent years. Since, it takes nearly two years from accepting shipbuilding orders to shipbuilding completion, this phenomenon also explains the recession of the shipbuilding industry in the first two years. According to the new orders, the shipping industry appears to be entering the recovery

Table 1
2009-2014 Chinese Shipbuilding Completions, New Orders and Hand-Held Orders

(Unit: Million dead weight tons)

	2009	2010	2011	2012	2013	2014
Shipbuilding Completions	4243	6560	7665	6021	4534	3383
New Ship Orders	2600	7523	3622	2041	6984	4868
Hand-held Orders	18817	19590	14991	10695	13100	15034

1.2.2 Weak Market Strain Capacity, Lack of Well-known Brands

In recent years, Chinese shipping enterprises mainly focus on traditional ship construction. Under such circumstance, these enterprises with weak resilience can not meet the demands of the international shipping market. As shown in Table 2, the majority of the orders are scattered singles,

phase. However, at present problems such as low ship cost, surplus production capacity, insufficient market demand still exist in ship industry, and the shipping industry will go through a longer period of adjustment. As a densely populated country with abundant labor, China has labor cost advantage compared with other countries, but key technologies in shipbuilding is not dominant, thus the production capacity of Chinese shipping industry is low.

and it is hard to undertake small single, large, extra-large singles. These undertook scattered singles also rely on the advantage of low labor costs. The overall shipbuilding industry competitiveness is not strong enough and there are few shipping enterprises which can lead the world trend, let alone world-famous brands.

Table 2
Three Key Indexes of Chinese Shipbuilding from January to June in 2014

(Unit: Compensated gross tons, CGT)

	Shipbuilding completions	New ship orders	Hand-held orders
Oil tanker	63	150	661
bulk carrier	263	635	2482
container ship	151	130	798
others	138	316	826

1.3 Practical Significance of Chinese Shipping Enterprises M & A

At present, the large-scale domestic shipping enterprises may go bankrupt in the face of challenges. Only by accelerating the integration of shipping enterprises and combining the enterprise structure adjustment with world-class shipbuilding enterprises, can the Chinese ship industry comprehensively improve the overall competitiveness. Actively mergers and acquisitions has very important significance for the shipping enterprises to face problems such as declining corporate earnings, reducing market competitiveness and the development predicament of dismal performance and it is also one of the important means for shipping enterprises to get rid of puzzledom, so as to survive, develop and grow. Through merger, the shipping enterprises can: A) Expand shipbuilding scale, improve competitiveness, get more market share. B) Develop new markets, access to high technology, improve product structure. The State Council explicitly points out in the new formulation of the “*Ship industry to speed up structural adjustment and promote the transformation and upgrading of the implementation*

plan (2013-2015)”, that the government should strengthen the integration of existing shipbuilding resources, emphasize on strengthening the integration of large shipbuilding facilities, concentrate resources, highlight the main industry, increase the mergers and acquisitions of small and medium sized shipping enterprises, provide the material basis for the declining shipbuilding industry, so as to enhance the core competitiveness of shipbuilding market.

2. FINANCIAL RISK IN THE PROCESS OF SHIPBUILDING ENTERPRISES MERGER

However, the mergers and acquisitions among shipping enterprises are not simple sailing. They are complicated economic operation which may lead to financial deterioration or financial loss. They will greatly increase the financial risk coefficient of mergers and acquisitions due to unreasonable decision of target value assessment, financing, payment and financial integration. Only by clearly recognizing the financial risks that may appear, and carrying out relevant research and preventive measures, can the enterprises reduce unnecessary losses in

the mergers. More specifically, the current financial risk in the mergers of ship enterprises is mainly reflected in the following four aspects.

2.1 Financial Risk in the Process of Value Assessment

The merger price decides whether the merger is success or not to a certain extent. Since high acquisition cost is easy to cause the failure of merger, a fair and objective value assessment of the target shipping enterprises is an important part in the merger. The financial risk of target enterprise value assessment is mainly due to the faulty judgment about the current value and future earnings of target shipping enterprises in the process of merger. And this leads the misunderstanding of the target enterprises' future earnings and expected time, and data information or operating conditions. And the assessment data about target shipping enterprises' value, as a basis to estimate the value of the enterprise, is mainly obtained from the financial statements. Since is also related with the actual development condition of shipping enterprise, it full of uncertainty and authenticity, which will also bring the problems such as valuation risk and merger risk, and make the development of Chinese shipping enterprises difficult.

For example, in 2008, the former Dalian Port Wantong Shipping Co., Ltd., Dalian Port Freight center, Dalian Port Shipping Agency Co., Ltd. merged to form the new Dalian Port Wantong Logistics Co., Ltd., It is a comprehensive logistics enterprise setting freight forwarders, shipping agents, ship transport, one-on-one full service in one. However, due to incorrect judgment of the three former companies for their own enterprise value and future earnings as well as having inadequate information, the corporate profits of the Dalian Wantong logistics Co., Ltd., in four years from 2008-2012, were lower than expected.

2.2 Financial Risks in the Process of Enterprise Financing

The enterprise merger activities often need a large amount of funds, thus the merger enterprises generally need financing in order to ensure sufficient funds. Financing from internal reserves and from external reserves are two basic ways for an enterprise to accumulate funds. There are other external financing ways to obtain funds, such as bank loans. However, many domestic and foreign banks classify ship industry as a high-risk industry, and they restrict credits and squeeze lending, which deepens the financing dilemma and increases the financing costs; as for selling equity, it will extend the time to get money, at the same time shareholders' earnings will reduce as a result of the equity dilution, which is contrary to the ultimate goal of business. As a capital-intensive industry, the shipping enterprises need a lot of money in the daily work, and most of the funds are used in the inventory. This part of the funds can not be realized in a short time because of long construction period and slow cash flow.

If the merger activity takes up a lot of liquidity, it will inevitably lead to ill capital operation and increases the financial risk.

According to the statistics of Wind Information, since 2013 a total of 158 ships enterprises in China has involved in merger and acquisition, with a total amount of 22.9 billion yuan. But after the merger and acquisition, these enterprises have not obtained better income and 75% of these enterprises have not met the expected return. Nearly 119 cases of ship mergers have poor performance. At the same time, the main financing ways of the Chinese shipping enterprises in mergers and acquisitions are shipowner's advance payment and bank loans, without actively optimize the financing strategy to broaden the financing channels such as internal financing within enterprise, venture capital financing, stock financing and other channel. This eventually led to the financing risk which was difficult to get effective control.

2.3 Financial Risk of Monotonous Payment

As for payment, there are cash payment, option payment and leverage payment. Cash payment manner is the main payment manner for shipping enterprises due to the limit of other payment manner and financial markets condition. But the necessary condition to choose this payment method is that the enterprises must have enough cash flow. And they also should have sufficient liquidity to ensure the enterprises' normal operation. Since most of the funds of shipping enterprise is limited, the cash payment may cause a decline in corporate cash flow ratio, which will bring greater financial risk for shipping enterprises.

Take the Shenzhen Shuangyin International Logistics Co., Ltd., as an example. In December 2013, the company decided to purchase the Guangzhou Yanghai International Freight Agency co., Ltd., the Yanghai company asked for a cash payment as much as 180 million yuan, but the Shuangyin company did not have enough money at that time, which eventually led to the undated suspension of merger. Certainly, even the Shuangyin Company could raise the corresponding cash, the merger also would cause the loss of the capital flow ratio of entire enterprise, thereby increasing its financial burden. In essence, the merger lacks scientific and theoretical guidance. Failure to effectively unify various payment methods will worsen the financial risk of enterprise mergers and acquisitions.

2.4 Financial Risks of Ineffective Integration

The value of merger activities comes from the integration of various resources that can be shared or transferred by both merger enterprises. Only by reallocating these resources, playing the role of all kinds of resources and infiltrating mutually, can the merger enterprises achieve merger synergies. Shipping industry is an industry with wide range and high industry relationship. Each enterprise has different pros and cons in shipbuilding capacity and shipping capacity, ship business structure, cost

control, technical level and competitiveness. Generally speaking, since the information asymmetry, whether the value of merger resource is true and reliable or not, will be reflected some time after the merger. Therefore, the effective integration of enterprise is a protection to achieve the purpose of merger. If the integration is not effective, the merger enterprises will be unable to produce anticipated synergy, which will bring more financial risks to M&A enterprises.

For instance, the Shanshui Datong Shipping Co., Ltd., founded in September 2003. In 2011, the company merged with the original Foshan Sanshui Danju Co., Ltd., and Foshan Sanshui Reed Port Shipping Co., Ltd. In early 2014, the company merged with the former Foshan Sanshui Fanjie Shipping Co., Ltd., Foshan Sanshui Changhang Ship service Co., Ltd., Foshan Sanshui Huangtang Shipping Co., Ltd., with a total of 97 ships weighing 12700 tons, or about 30000 ton carrying capacity transferred to Datong company. But due to poor shipping market prospects, the business of these enterprises were seriously damaged, causing that the three companies after mergers had always put saving costs at important position of enterprise management. And, it to some extent hindered the cooperation among the three companies. At the same time, the companies original goals, management modes and management concepts have exist obvious differences, making it difficult to realize effective concept identity, unification of operation pattern and resource integration among these companies. Thus, the Datong Company had not obtained a good cause until October 2014.

3. PREVENTIVE MEASURES OF CHINESE SHIPPING ENTERPRISE MERGER FINANCIAL RISK

The financial risk goes throughout the merger activity. Even if the enterprise has its own advantage, however, any error in any part of the acquisition process could bring a huge financial risk to merger enterprise, and the error will drag the merger enterprise down at last. Therefore, to ensure that the shipping enterprise is able to achieve the desired business objectives, it is necessary to develop targeted preventive measures to strengthen the control of financial risks, so as to promote the sustained and healthy development of shipping enterprises.

3.1 Pay Attention to Relevant Policies and Regulations Changes

The Chinese laws and regulations and industry policies have a profound and positive impact on merger activity of shipping enterprise, thus the merger enterprise should focus on the changes of relevant policies of ship industry. Particularly, during the merger activity, changes of policies, laws and regulations may bring unpredictable variables. In this regard, shipping enterprises should

timely pay attention to the change of industry policy and laws and regulations and adjustment, and then adjust the ship targeted business strategy, so as to maximumly avoid the adverse effects of uncontrollable factors. At the same time, countries should also improve the merger idea of Chinese shipbuilding enterprises mergers and acquisitions, and standardize the process of mergers and acquisitions.

3.2 Improve the Value Evaluation System of Shipping Enterprises Merger

Merger value assessment needs merger enterprise to have a reasonable and accurate judgment on target enterprise's present and future economic value, strictly control and prevent the unreal and inaccurate assessment results. Therefore, merger enterprise must collect information about target shipping enterprises, obtain their detailed financial statements before the merger, and carefully examine and verify the specific project data of financial statements, evade the information distortion caused by improper accounting methods, and fully guarantee the reliability of financial statements. In addition, it should also conduct a market survey of assets of the target enterprise, analyze the possible financial risks, use comprehensive evaluation methods to grasp the true value of the assets of target shipping enterprises, in order to provide data support for an accurate assessment about price of the target shipping enterprises. In addition, the merger enterprise must carefully select, grasp and understand the featured outstanding expertise of shipping enterprise in order to occupy a strong position in merger negotiations, and complete the merger with favorable price.

3.3 Expand the Financing Way of Shipping Enterprises Merger

In the perspective of shipping enterprises, the financing ability and the method of financing to complete the merger and acquisition activity, have a decisive influence on the future development of shipping enterprises. In addition to conventional financing ways such as financial loans, the shipping enterprises also should expand and innovate the financing methods, such as financing lease, buyer's credit, the establishment of marine industrial investment funds, the issuance of enterprise bonds and non-financial corporate debt financing tools. They also should make network financing announcements, hold financing investment activities, and strengthen cooperation with other enterprises. The large enterprise groups and backbone shipping enterprises can rely on their own unique shipbuilding technologies and product advantages to attract investors to make equity investments. In the specific choice of financing methods such as the debt financing, the enterprises should calculate the risk of debt financing ability and liabilities point according to its own economic conditions and prospects for the development, so as to control the liability scale within the range of its liquidity; for the equity financing, the enterprises must

make clear the consumption time needed for equity financing, to prevent missing any good opportunity due to long consumption time. At the same time, equity dilution of enterprises which may weaken the control of the enterprise also should be taken into consideration.

3.4 Innovate the Payment Way of Shipping Enterprises Merger

Improper selection of payment in the merger activity can seriously affect the flow of funds, especially for capital-intensive shipping enterprises, thus the enterprises need to break the payment relying on cash payment to improve the success rate of merger. And they also should actively take advantage of the policy that the state encourages the financial institutions to increase shipping enterprise merger, overseas merger, as well as the credit financing of the transformation and products structure adjustment of small and medium-sized shipyard business, innovate further merger payment methods to reduce cash payment and increase the proportion of equity and debt payment way, so as to achieve the target enterprise merger payment through the combination of a variety of payment methods. Meanwhile, the merger enterprise should prepare a detailed capital budget tables based on the acquisition of funds payment, payment amount and payment time. To fully grasp the dynamic capital during operation, timely monitor capital changes, striving to minimize the financial risk of payment in the process of mergers and acquisitions.

3.5 Optimize Integration of Shipping Enterprises Merger

Whether the merger and acquisition can have the expected effect not only depends on the effective integration of assets, but also depends on the management concept, enterprise culture, human resources. And the success of enterprise financial integration after merger is the key to improve the shipping enterprises' core competitiveness. The merger of ship enterprises should take the stronger and distinctive enterprise as a leader, form a ship industry group and an industrial chain, actively revitalize the good assets of the enterprise after the merger, and disposal of non-performing assets, integrate assets, liabilities and internal performance evaluation of shipping enterprises, thus improving the capital management and operating efficiency and protect the maximize interests of the enterprise. Under the current circumstance that the shipping enterprises earn little but bear high ship price, freight and cost, the enterprise after the merger still needs to build systematic management system

and comprehensive budget. Particularly, they should strengthen the cost management of relevant enterprises in the merger breaking-in period, set up comprehensive target cost management system, realize the coordinated development of merger enterprises, improve the management efficiency and market competitiveness of the enterprise. Only by successfully integrating all kinds of resources after the merger and fully realizing the merger synergies, can the enterprises establish new core value and improve the ability to resist risks in market volatility.

CONCLUSION

At present, the Chinese shipping enterprises have small production scale and inadequate technology strength reserves. Therefore, integration of resources through mergers and acquisitions to improve industrial concentration is the inevitable trend. Since the shipping enterprise is capital intensive, technology-intensive and labor-intensive, and risk-intensive, the enterprise should treat mergers and acquisitions with caution, draw great attention to the financial risk of mergers and acquisitions, make efforts to do a good job in risk identification, risk assessment, risk prevention, make risk response, cut losses brought by financial risk. Only in this way can the shipping enterprises truly achieve the merger strategic goals.

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