

Financial Risks of Chinese Enterprises' Cross-Border Mergers and Acquisitions

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Supported by the Social Science Research Program of Jilin Education Department during the *Eleventh-Five Year Plan* (Jilin[2014]No.23).

Received 14 June 2014; accepted 16 August 2014
Published online 15 September 2014

Abstract

With overall strength of Chinese enterprises and national *going out* strategy, cross-border M & As initiated by Chinese enterprises have been booming. However, compared with developed countries, Chinese enterprises started their M & As late and lacked experience and professionals. As a result, Chinese enterprises faced with numerous risks in cross-border M & As, especially with the financial risks. This paper, based on the analysis of Chinese enterprises' cross-border M & As cases in recent years, explained how the financial risks formed and finally came up with efficacious precautionary measures.

Key words: Chinese enterprise; M & As; Financial risks

Xiao J. (2014). Financial Risks of Chinese Enterprises' Cross-Border Mergers and Acquisitions. *Management Science and Engineering*, 8(3), 27-30. Available from: URL: <http://www.cscanada.net/index.php/mse/article/view/5213>
DOI: <http://dx.doi.org/10.3968/5213>

1. OVERVIEW OF FINANCIAL RISKS OF CROSS-BORDER M & AS

Financial risks refer to the reimbursement risks and change of returns to shareholders triggered by financing decision in the process of enterprises' cross-border mergers and acquisitions (abbr. M & As). Enterprises often go through three phases—valuation, financing, and

payment—in the process of cross-border M & As. Based on valuation, financing, and payment, decisions affect enterprises' assets structure and even their solvency and returns to their shareholders. In addition, cross-border M & As use an international currency for most countries. Change in exchange rates affects corporate earnings, as well as shareholders' returns. Therefore, there are four main types of financial risks: valuation risk, financing risk, payment risk, and exchange rate risk.

2. STATUS OF CHINESE ENTERPRISES' CROSS-BORDER M & AS

Combining with *going out* strategy, Chinese enterprises upgrade their strength and participate in the context of economic globalization. Chinese enterprises begin to go abroad, merging and acquiring foreign ones. Although Chinese enterprises' cross-border M & As started late, China has become the world's fifth cross-border acquiring power in 2009. Status of Chinese enterprises' cross-border M & As is as follows:

2.1 Increases in the Number and Scale of M & As

In the year of 2008, Chinese companies completed only 30 cases of cross-border M & As, costing less than \$ 9 billion. In the year of 2013, Chinese companies completed 99 cross-border M & A, amounting to \$ 38.5 billion. The number of M & As doubled, while the total amount grew more than three times.

2.2 Large State-Owned Enterprises as M & As Subject

Compared with private enterprises, large state-owned enterprises have more their own capital. It is easy for them to get loans and finance, so Chinese cross-border M & As are mostly done by large state-owned enterprises. On the Summer Davos Forum in 2013, Andrew, Global Chairman of KPMG International, pointed out that 86%

of the China's foreign investment came from China's state-owned enterprises. By far in China, the largest cross-border M & As was initiated by China's state-owned enterprises CNOOC. On February 27, 2013, CNOOC successfully acquired Nexen Corp., a Canadian company, by spending \$ 15.1 billion.

2.3 Cash as the Main Form of Payment

China's market economy status has not been recognized by all countries, and, to a certain extent, Chinese enterprises are discriminated in cross-border M & As. In addition, China's financial market is not perfect. In order to gain direct control of the acquired enterprises, Chinese enterprises mostly pay by cash. According to Bloomberg, 79.4% of China's cross-border M & As made their payment by cash, 3.3% by stock, and only 1.18% by other mode.

2.4 Increased Impact of Exchange Rate on M & As

Before the year of 2012, the floating range of RMB against U.S. dollar was only 0.5%. Since 2012, China's central bank adjusted the floating range of RMB against U.S. dollar to 1%, and on March 15, 2014, extended it to 2%. Compared to the previous fixed exchange rate, the change of exchange rate significantly increased, which made the Chinese enterprises begin to consider the impact of exchange rate change on acquisition costs in their M & As.

3. FINANCIAL RISKS FACED WITH CHINESE ENTERPRISES IN CROSS-BORDER M & AS

Chinese enterprises began to participate in cross-border M & As actively only in the past ten years. The lack of experience made it difficult to accurately value the target enterprises. China's financial market is not mature, it is difficult for Chinese enterprises to finance and choose payment mode. At the same time, the international financial market fluctuates, and RMB is not an international monetary. Cross-border M & As is done by dollar or euro, which brings risks to Chinese cross-border M & As.

3.1 The Valuation Risk

Determination of the transaction price of M & As is actually a game playing by initiators and targets of M & As. Under normal circumstances, the initiators can not fully grasp the information of target corporations, so it is difficult to estimate accurately. In general, valuation price will be higher than the actual value of the target enterprise. Overvalued price causes the main type of financial risk faced with the cross-border M & As performing by Chinese enterprises. This risk is reflected in a series of cases, such as TCL and Thomson M & A, China Investment Corporation's investment in Blackstone USA, acquisition of United Commercial Bank (UCB) by China Minsheng Bank (CMB).

Take the failure of acquisition of UCB by CMB as an example. After the outbreak of the subprime crisis in American, western banks were shrinking. The CMB decided to merge the UCB in the United States. CMB injected funds to UCB twice in 2008. After the first injection, the bank's market value shrank by 70%. CMB didn't take this as a sign of warning, it injected again after that. Until September, 2009, financial investors suddenly announced the existence financial concealment by UCB, and in November UCB was permanently closed. In the process of M & As, CMB overvalued UCB and eventually increased the loss.

How much information about target enterprises that acquirers get is vital to evaluation. Even if acquirers get enough information, it is so subjective to calculate target enterprises' real value. In the CMB M & A case, there existed big difference between subjective evaluation and real value of UCB. After the first injection of capital, the biggest mistake for CMB was that it took the devaluation of UCB's stock as an opportunity of another capital injection instead of warning.

3.2 Financing Risk

Financing decision plays a vital role in the M & As. It is the foundation of pricing decision and also the condition of payment decision. The major financing channels used by enterprises in their cross-border M & As are their own funds, stock financing, and bank loans. At present, Chinese enterprises mostly use their own funds in acquisitions, resulting in increasing financial problems.

In the case of acquisition of Alcatel by TCL in the year of 2004, the significant adverse effect on TCL was due to bad financing decisions in M & As. In 2003 TCL's annual profit was only about CNY ¥560 million, while Alcatel's amount of loss on TV sets and DVDs was as high as €120. TCL did not achieve profitability immediately after M & As. TCL not only was unable to repay debt generated from acquisition financing, but also increased the new debt. After that, TCL's financial risks continued to expand.

Financing risk is composed of two parts, one is the environmental risk of financing, and the other is the debt risk of financing. Environmental risk of financing associates with the country's macroenvironment and the maturity of its financial markets, that is, the more capital markets are developed, the better the macroenvironment is; the more financing instrument may be used, the more acquirers can get financing with less cost. Debt risk of financing is related to the structure of repayment period. Although, as a whole, macroeconomic environment is well in China, the financial markets are not mature, and furthermore, unreasonable repayment structure will bring financing risk to acquirers.

3.3 Payment Risk

Payment decision is based on valuation decision and financing decision. At present there are mainly three kinds of payment mode: cash payment, equity payment,

and leverage payment. Chinese enterprises generally use cash payment, which is the most risky one in their cross-border M & As. This payment mode can effectively help enterprises obtain the control of target enterprises successfully, but it increases financial pressure and the debt burden of Chinese enterprises, which easily leads them to liquidity risk and financial difficulties.

In the case of acquisition of Fortis Group Belgium by Ping An Insurance (Group) Company of China, Ltd. (Ping An), from 2007 to 2008, Ping An bought Fortis's stocks three times from secondary markets, accounting for 4.99% of the total shares, becoming the largest shareholder of Fortis Group. However, by 2008 November, Fortis's share price fell 96% cumulatively, and Ping An suffered huge losses. In order to make cash payment in the secondary markets to get Fortis shares, Ping An published additional its own shares and also increased debt. As a result of this M & A, Ping An's financial risk was increased; the ratio of assets and liabilities was as high as 88.47% in 2008.

China's financial market established late, and is in a progressive stage of development. In immature financial markets, there are limited financing instruments that can be used for acquirers. Most of the capital comes from acquirers' own capital, bank loans, or government grants. The use of their own capital takes up a lot of corporate liquidity, weakening the ability of dealing with emergencies with their liquid capital. For bank loans, in the immature capital markets, banks monopolize capital, ask for monopolized profits, and may have rent-seeking behavior. As a result, enterprises get bank loans only after paying for large cost. Government grants usually support specific industries and the related audit procedures are very complicated. Even if the companies were in the field of government subsidized industry, they might miss opportunities to complete M & A due to complicated procedures and lengthy audit.

3.4 Exchange Rate Risk

RMB is not an international currency, and its circulation is limited in the world, so it can not be used in international transactions. Therefore, Chinese cross-border M & As need foreign exchange, under normal circumstances, dollars or euros. For Chinese enterprises, whether to borrow or buy foreign exchange, there is time difference between the day of signing contract and of the actual payment, during which the change in exchange rates will affect the costs of M & As, so that enterprises face foreign currency risk. In addition, when enterprises settle their income in foreign currency, or pay debt, exchange rate change will lead to the uncertainty of their future earnings.

In the case of acquisition of Aurukun project by Aluminum Corporation of China Limited (CHALCN), exchange rate risk was obvious. In March, 2007, CHALCN bid Australian Aurukun bauxite development project by \$2.92 billion. During the period of bid, Australian dollar exchange rate was about 0.68, and in 2008 July, it appreciated to 0.9848. The Australian dollar rate fluctuated nearly 40%. While CHALCN deposits in

dollars, the cross-border M & A project led to huge losses because of exchange rate fluctuation.

Boundary condition of cash payments is $(V_{AB}-V_A)/(1+a) \geq C_p \geq V_B$, where V_{AB} is the acquirer's cash flow after M & A, V_A is the acquirer's cash flow before M & A, a is the cost rate of cash payment, C_p is the amount of cash, and V_B is the value of target enterprise. When $(V_{AB}-V_A)/(1+a) < C$, the cash paid could not be recovered, and the acquirer would suffer the loss. Otherwise, V_{AB} is an estimated value and will be affected by the valuation ability of acquirer. Furthermore, the change of a cannot be controlled completely by the acquirer. Therefore, the use of cash payment will lead to uncontrollable risk.

In the process of payment, companies must make reasonable arrangement for funding. As to payment arrangement, if enterprises arranged the time structure and scale structure unreasonably, a relevant factor, such as cost of corporate debt, tax cost, and intermediate costs, would increase and make the increase of post-merger cash flows less than the actual cash flow, resulting in acquirers' ultimate loss, that is, they would suffer enormous pressure and expose themselves to financial distress.

4. COUNTERMEASURES OF FINANCIAL RISKS

In this part, we analyzed the causes of financial risks in Chinese enterprises' cross-border M & As and proposed the corresponding countermeasures.

4.1 Prevention of Valuation Risk

For these businesses involved in cross-border M & As, accurate valuation is the first step to the success. Valuation affects the whole process of M & As. Therefore, it is very important to avoid valuation risk.

First, hire a professional team of valuation. Since the Chinese enterprises lack experience of cross-border M & As, it is difficult for acquiring enterprises to grasp the main points in the process of valuation of target companies. It is more likely that target firms would hide key information from them. Usually a professional valuation team has rich experience in M & As, better information collection, and analysis ability, and usually it is able to obtain the information needed from analysis through its unique channels; thereby it helps reduce the risk of enterprise valuation.

Second, choose scientific methods of valuation. Enterprises can choose a relatively accurate estimation methods based on the actual situation and may also give a certain weight to each valuation approach and make comprehensive valuation, in order to disperse the risks of each valuation method.

Third, adjust financial statements. Financial statements can only reflect the past performance and cannot reflect the future one. At the same time, the financial statements cannot take the key points of business out of balance sheet included. In order to overcome these adverse

factors of valuation, acquiring enterprises can adjust the financial statements of target companies according to the information they got about the target companies. They can include the business other than those shown on balance sheet into account, give the weight coefficient of financial indicators and make a comprehensive valuation of the target companies.

4.2 Prevention of Financing Risk

For Chinese corporation, financing risks arise due to the immaturity of China's financial markets. Chinese enterprises have limited choices of financing channels to fund their M & As, so it is difficult for them to obtain enough funds needed in M & As. At the same time, there is no reasonable capital structure when arranging financing. Therefore, for the above reasons, we proposed three countermeasures.

First, improve the financial markets and support the development of private credit in order to provide cheap financing for M & As in the short time. Financial innovation will lead to creation of new financial instruments to meet the needs of companies and investors to facilitate corporate financing and raise enough funds, while decentralizing financing risks

Second, use innovative financing methods. For example, in 2010, in order to finance acquisition of Volvo, Geely Automobile used both fund financing and government funding. In order to attract local government funding, Geely promised to build factories in the cities whose local governments have funded it. Eventually, Geely gained \$3 billion fund from Chinese local companies, including \$1 billion from International Daqing, \$1 billion from Jiaerwo Shanghai, and \$1 billion from Chengdu Bank.

Finally, set up a reasonable set of repayment structure. Before enterprises involve themselves in M & As, they should take fully consideration of how to pay debts in two consequences of success and failure in M & As respectively. When companies fail in M & As, enterprises should have sufficient liquidity to repay debt resulted from the initial investment. And if companies can successfully achieve acquisition, then companies should make sure that their repayment time, scale, and structure can math their cash flow, scale, and structure after the merger of target companies.

4.3 Prevention of Payment Risk

Payment risk results from the dependence of Chinese enterprises involved in cross-border M & A on cash payment and unreasonable payment structure arranged by these enterprises. Therefore, in order to prevent payment risk, Chinese enterprises should adopt various payment methods in their cross-border M & As and arrange payment structure reasonably. Lenovo gives us a very good demonstration. In December, 2004, Lenovo purchased IBM's PC business by \$ 1.25 billion, \$ 0.65 billion in cash plus \$ 0.6 billion by shares of Lenovo. This payment method greatly reduced the pressure of cash

flow pressure on Lenovo. It was shown that debt rate of Lenovo remained at normal level in 2004.

4.4 Prevention of Exchange Rate Risk

Wider scope of Chinese exchange rate volatility helps RMB internationalization and also brings more challenges to enterprises who participate in cross-border M & As. Exchange rate risk will further intensify, so we need to take positive measures to avoid it.

First, internationalize RMB gradually. If RMB become an international currency, Chinese cross-border acquiring enterprises can use the RMB directly, and then there is no currency exchange and no exchange rate risk. At present the achievement of RMB regionalization is only a small step in the process of RMB internationalization.

Second, adopt different hedging strategies. They may prevent the risk of exchange rate by choosing different financial instruments and combining them to hedge in the foreign exchange market. There are many financial instruments we can use, such as: the foreign exchange forward, foreign exchange futures, foreign exchange options, and currency swaps.

CONCLUSION

The paper introduced the status of Chinese enterprise cross-border M & As, and then analyzed the financial risks faced with Chinese enterprise cross-border M & As, that is, evaluation risk, financing risk, payment risk, and exchange rate risk. In order to overcome or even prevent these risks, Chinese enterprises should accumulate experiences of cross-border M & As performance and take use of innovative financial methods. Chinese government should promote the financial markets, support financial innovation and promote RMB internationalization. By their all efforts, Chinese enterprises will perform better in their cross-border M & As.

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