

## The Motive of Enterprise Restructuring and Risk Prevention

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### Abstract

Enterprise restructuring is inevitable in the process of the modern market competition. This paper analyzed the motivation and risks of the enterprise restructuring from the aspects of macroscopic and microscopic view, and further proposed approaches to avoid these risks.

**Key words:** Restructuring of the enterprise; Motivation; Risk

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### INTRODUCTION

Restructuring of the enterprise is reorganization on property relations, debts, assets and structure of management, to make full use of existing resources and optimize the allocation of resources. Restructuring of the enterprise is inevitable in the environment of market competition, in order to control market, acquire new technology, transform and enter new industry or market. It is a strategy of competition in market, if utilized properly, it would expand the size of the corporation, improve the business environment and economic returns, strengthen the competitive power. On the contrary, it may burden the company and led to fall of competitive power, even bankruptcy. The process of restructuring is a test of the decision making, management quality and resource

condition. How to lower and evade the risk is becoming an urgent problem in the process of restructuring.

### 1. MOTIVE OF THE RESTRUCTURING

Motive is the beginning of the action. The motive in the process of restructuring is called restructuring motive. Restructuring action is a complex economic phenomenon. The motive is marked by diversification. Different corporations, phases, places and time led to different motives. But based on capital appreciation, the goal of an enterprise is to gain profit and increase capital. On the whole, restructuring is carried out by focusing on profit maximization and market competition, the fundamental motive is to pursue synergy, development and strategic objectives.

#### 1.1 The Macroscopic Economic Motives of the Restructuring

Macroscopically speaking, enterprise restructuring is pushed by national policy, especially so to SOE, due to the ownership and social duties. First, restructuring could promote SOE reform; help SOEs coming out from difficulty. Under the original ownership, the confusion of the ownership and defective incentive mechanism makes the business efficiency stay at a low level. Additionally, the social functions and historical burdens have created disadvantages for SOEs in the process of competition with other enterprises with different ownership nature, which led to large losses and social problems. With regard to this, restructuring is becoming an effective measure to solve SOEs' problems. Specifically speaking, SOE restructuring could ameliorate the structure of ownership and stimulation and Restriction Mechanism for enterprises enhance the efficiency of those enterprises which have carried out restructuring. Second, restructuring meets the needs of specific macro economic policies. It could further the adjustment of industrial structure and enhance

the efficiency of resource allocation, and finally realize the macro economic objectives.

Due to the influence of financial crisis, the world economy has entered into a phase of adjustment. Experience shows that this phase of adjustment is a good time for enterprise restructuring. In the coming period, merger is becoming a trend. From the respect of external environment, the asset price has fallen down in the global market, new merger opportunities have emerged.

In August 28<sup>th</sup> 2010, the State Council issued “opinions on promoting enterprise merger and restructuring”, which boosted the merger and restructuring. “opinions” proceeded from actual situation, improved the policy system of the merger and restructuring, relieved the burden on enterprises, presented several policy measures including realizing tax preference, increasing capital investment and financial support, encourage independent innovation and technical progress, giving play to capital market, improving land management policy, solving problems of claims and obligations and staffing.

### 1.2 The Microscopic Economic Motives of the Restructuring

In a severe competitive market, an enterprise can't survive without development. Normally, the development could be achieved through internal investment or merger and restructuring, but merger and restructuring has higher efficiency. “There isn't any American enterprise has prospered without merger, nearly no major enterprise developed through internal expansion”, argued by American famous economist George Stigler.

Due to the construction cycle, resource acquisition and allocation, the enterprise would be trapped through internal investment, further slow down the development. Merger and restructuring could achieve scale expansion, sharpen the competitive edge and crush opponents. Enterprises could face up barriers like capital, technology, channel, customer and experience when entering a new industry, this would then increase the cost and risk. But they could avoid those barriers through restructuring to control another enterprise, and then to enter this industry with low cost and risk.

Most SOEs in China have experienced planned economy. At that time, the industrial layout and Industrial Division were specialized. Enterprises were connected through mandatory plan. Under planned economy, research and production, design and construction, trade and production, internal trade and external trade, all of these enterprises were divided, they were contacted by plan. But problems have emerged in market economy, many enterprises are dysfunctional. In order to solve these problems, SOEs are looking for structuring opportunities to get the synergy effect. This means that after the restructuring, the overall effect of the new enterprise could exceed the addition of the effects of the original enterprises, consequently increase the efficiency of the business operation and reduce the cost, and bring scale merit.

## 2. RISK PREVENTION OF THE RESTRUCTURING

The risk of the restructuring refers to the possibility, which could cause failure for the expected objective of the restructuring due to some uncertain factors. It is fundamental to the restructuring project. According to different phases, it could be classified as valuation risk (before the process of restructuring), financing risk (in the process of restructuring) and integration risk (after the process of restructuring).

### 2.1 Valuation Risk Prevention

In his book *planning offensives*, Sun Zi said: “Knowing the enemy and know yourself and you can fight a hundred battles with no danger of defeat. If you only know yourself, but not your opponent, you may win or may lose. If you know neither yourself nor your enemy, you will always endanger yourself. Market is like battle field, before making decision for strategic restructuring, the enterprise should know the enemy as well as itself, and then get to ‘fight a hundred battles with no danger of defeat’”. The valuation not only focuses on the value of target enterprise, but more on the value of current enterprise. When making strategic decisions, many enterprises only expect the good result but not the complexity and risk. They emphasize too much on using restructuring to expand the business, but this is beyond their capability, finally let to risk of huge expenses.

Enterprises should understand the macro policy and make correct judgment about market trend. Before the restructuring, decision makers should call in legal services and market research institutes to comprehend related national, local and industrial policies and regulations, grasp the market trend, and forecast related measures from the government. In the context of full comprehension of the environment, the enterprise should consider its current value and if it qualifies as the mainstay of the restructuring. The condition to be a qualified mainstay includes: 1. having strong economic power as well as capital, technology and management ability to hold companies and replace assets. 2. Having clear objective, which aims at long-term development? 3. Having strong market expanding ability and integrated management, able to absorb assets from controlled corporates. All of these conditions are necessary; otherwise the restructuring would be very risky.

Valuation risk of the target enterprise is caused by wrongly assessing the value of the target enterprise. The risk includes: 1. Lack of analysis and penetration capability. 2. Lack of comprehensive analysis of the objective environment of the target enterprise. 3. Decision of the business scope of the target enterprise. 4. Decision of the size of the target enterprise. 5. Merging ability of the target enterprise.

The restructuring can't succeed without following

the laws of economics. It is important to understand the market demand, choose the right target market prospectively, assess the ability to enter a new market, avoid hasty decision.

## 2.2 Financing Risk Prevention

Overvaluing the target enterprise and profitability may cause the acquiring firm to bear unexpected burden. Acquiring firm can hardly bring reward from the acquisition because of the high acquisition price. This would in turn lead to financial risk.

Usually the financing channels include capital in hand, borrowing, bond and stock. There are two factors which would affect the financing risk. The first one is financing capability. This is the most important factor to affect finance. It includes internal financing and external financing. Internal financing is affected by the amount of capital in hand and tax and depreciation policies. Usually the cost of internal financing is low. External financing includes debt financing and equity financing. These are affected by the number of financing channel, profitability, capital structure and attitude to the firm from market. The second one is financing structure. This is the proportion of the debt capital and equity capital. Debt capital includes short-term debt and long-term debt. The rationality of the financing structure is a main factor to affect the financing risk. When the restructuring can't meet the expectation and the profit rate is lower than debt interest, the risk of interest payment and capital repayment would occur. When the equity is the main part of the financing structuring, issuing new shares means partial control power would then transfer to new shareholders. If too much shares were issued, the original shareholders would lose partial control power, and may face up the risk of being purchased.

The payment method of restructuring consideration, whether by cash payment or stock payment, not only affects the financing risk, but also the tax risk. Policy of Fiscal and Taxation [2009] #59 ruled that stock payment need to present a certain portion in the restructuring structure which enjoys tax preference, otherwise the tax preference would not be available for the restructuring

In order to minimize the restructuring risk and avoid paying high purchasing price, the buyer should attach importance to research before the restructuring, financial review and assessment to the target enterprise and acquiring enough information about the target enterprise. The most important step to the analysis of the target enterprise's market value is the analysis of the financial position. The acquiring firm should make sure that the financial report can reflect the financial position accurately. Meanwhile it should reckon its own cash and when the cash is available and use it properly.

The acquiring firm also needs to choose the method of payment flexibly to reduce the payment risk.

## 2.3 Integration Risk Prevention

It is only a phase achievement for the acquiring firm to acquire the operational control of the restructured enterprise. The success of the restructuring is judged by the integration. Integration creates value, synergistic effects could only occur after achieving effective integration of the management, research, production, marketing and finance. If enterprises lay emphasis only on the process but not the integration, restructure without management and cultural fusion, the risk of failure would be raised.

The restructuring strategy is the directional adjustment. It's a definition to the development in the future. If the strategy of the acquired enterprise disaccords with the one from the acquiring firm, it would be difficult to give play to the synergistic effect. It is important to plan the strategy of the target enterprise, make all the business units cooperate with each other. In addition, resource sharing system should be established to concentrate high-quality resources, develop core businesses, and achieve specialized operation.

The employees in acquired enterprises may resist the new management system in the process of management system integration. Therefore, before the integration, the acquiring firm should learn about the detail and improve the weakness of the original management system in acquired enterprise. Innovation is also need if necessary.

The key to the success of restructuring is the personnel integration. After the restructuring, the acquiring firm should lift the worries for the employees in target enterprise, make steady personnel policy, eliminate the precaution between employees and make the enterprise identified by them. The following step is to reorganize different departments according to new strategy, business and system. Usually the people in finance, law and R&D department could be merged to achieve economics of scale and decrease the cost.

Enterprise culture, which could influence every aspect of the operation, is the fundamental part of the business. Enterprise restructuring is not simply transfer shares and assets, but more to fuse different cultures. The physical integration could be achieved in a short term, but the cultural fusion is a long-time job. Long-term divergence on operation philosophy, value and management policies could lead to serious conflict. The cultural fusion should be developed step by step scientifically. Firstly, the top of the enterprises should pay more attention to the cultural fusion. Secondly, study the culture in acquired enterprise, analysis the fundamental element, realize the feature and make a scheme for cultural fusion. Thirdly, choose a proper mode for fusion. Fourthly, Promoting continuously enterprise culture management and make long-term management on culture. The development of the culture is driven by the cultural exchange, confrontation, conflict and competence. The restructuring offers exactly the opportunity for the rapid development of the culture.

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