International Journal of Business and Management
www.ccsenet.org/journal.html
Vol. 4, No. 1
January 2009

The Study of Financial Risk in M&A

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Abstract

M &A is a risky activity. M & A business, whether in the preparation stage, or in the operational phase of the merger, or post-integration phase, will be accompanied by a large number of uncertainties. These uncertainties brought about by mergers and acquisitions could lead to a huge financial risk. In particular, under the current pressure of RMB appreciation, more domestic enterprises have chosen the path of M & A. This article focuses on the various stages of the merger vulnerable to financial risks, and risks of these raised a number of preventive measures.

Keywords: M&A, Financial risk, Preventive measures

1. The background analysis of M&A

In the west countries, M&A have a history about more than 100 years, and transactions have been expanding. The 5th wave of global mergers and acquisitions peaked in 2000.In our country, M&A become more and more popular. For example, many companies Step up the pace of overseas expansion and M&A. However, under the pressure of RMB appreciation, many companies choose M&A to tide over the difficulties. As we known, M&A must have risks, for instance: estimate of target firms, choice of transaction method, or financial risks. How can avoid these risks? Which method should we choose? This is the purpose of this article.

2. The cause of financial risk in M&A

2.1 Overestimate or underestimate the value of firms lead to the risk

2.1.1 Information asymmetry is the major factor which impacts the estimation

Because of Information asymmetry, target firm always conceal adverse information and exaggerate good information. Bidders also exaggerate their strength, disclosure between them are inadequate or distorted. Therefore, failures which result from rash actions can be found everywhere. There are many information risks, for tow important examples: first, equity risk, equity is very important in any firms, however there are difference between the offer information and the real, these illusive information threaten the succeed of M&A; second, debt information risk, if this risk would not be found, a large debt will fall to the bidders with no reasons.

2.1.2 Lack of rational evaluation methods

There are three evaluation methods: replacement cost method; market value method; the present value of earnings, between them, market value method has high request about Information symmetry, for firms can make an exact evaluation only when the information is high symmetry. However, in our country, the level of information symmetry is lower, little firms adopt this method. Most of them adopt replacement method and the present value of earnings method. These two methods also have disadvantages, replacement cost reflects the historical cost which can't reflect the future profitability; although the present value considers the value-added revenue, it has also obvious flaws, that is, future revenue expected is very different.

2.1.3 The system of assessment is not perfect

Here is the assessment system in the whole industry, rather than a simple method. At present, our country is lack of independent, professional bodies, the majority of overseas M&A is completed by the enterprises themselves, on this point there is a certain degree of irrationality. Because lack of professional skills, and there is no habits of long-term follow-up observation, and can't receive long-term and stable information and so on, all this lead to the result can't follow the expectation.

2.2 Risk result from the choice of transaction methods

2.2.1 Cash method

If you expect there is no risk in cash payment, you must make the present value of incremental of expected cash flow net present value is greater than the paid, whereas shareholders of bidders will bear the loss. When the cost of cash payment is expansion, and face huge debt burden, and the source of funding deadline is unreasonable structure, or lack of short-term financing, it is easy to bring to the acquisition of liquidity pressure. At this time if the new company has a low level of liquid assets, it will have a liquidity risk, and liquidity risk is the most outstanding performance of cash payment.

2.2.2 Common stock payment

On the whole, the major risk of stock payment comes from the value-added expectation, the stock exchange expand the shareholder's base, leading to the decline of earnings per share, when investors doubt the target firm's ability of getting back earnings per share, the stock price of bidder will decline because of dilution of earnings per share. It shows that the proportion of equity dilution resulting from the convertible is the most important means of payment risks.

2.2.3 Leverage payment

Leverage will inevitably bring the debt risk. Leverage is the bidders make target enterprise assets as collateral for loan to banks, post-merger success with the production and operation activities generated cash to repay the loan. The aim of leverage payment is to solve the fund problem by using the loans, and hope that the acquisition can receive effective leverage benefit. This method is bound to achieve a high return on investment and it need stable cash flows to complete. Otherwise, the acquiring company may go bankrupt because of can't pay off the higher debt.

2.3 Financial risk resulting from adverse integration in the post-merger

In the integration period, when the role of risk factors come to a certain extent, that will lead to the occurrence of financial risks. According to the manifestations, financial risk can be divided into the mechanisms risk, financial risk and operational risk. Mechanisms risk means in the integration period, because of setting up financial institutions, financial functions, financial management system, update of financial organizations, financial synergies, and other factors, the financial income and financial gains of bidders occurred in a departure from expectations, and thus suffer losses. Financial risk means financial income and financial revenue will depart from the expected if there is something wrong with the financial running. In the process of asset management, bidders control their assets, costs, financial operations, liabilities, profits, and other financial functions in accordance with the principle of maximizing the synergy earnings in order to achieve the final purpose of mergers and acquisitions. However, the uncertainty of macro-and micro-environment affect the decision-making process in the financial operation, which lead to financial risk. Operational risk means financial risk result from inadequate monitoring of financial activities.

That shows process ending is not equals to final succeed, financial integration is the end of financial management in the M&A, and is also the most important aspect, if it failed it means the whole M&A is failed.

3. Prevention measures of financial risk

3.1 Prevention for information risk

The important role for this prevention is to rule out the false information through legitimate and effective method and then to get real, comprehensive information. For the equity risk, there are two main points: an appropriate cautiousness and disclosure. Appropriate cautiousness means a process of investigation, review and evaluation. Bidders must investigate the external and internal situation of target firms, in order to find some government activities which restrict property right transaction. Disclosure means that the target company should tell the bidders just as relevant materials, information, debt claims and so on. Disclosure must be true, complete and not misleading. As for the debt risk, we must first choose the best method; second, you must make an agreement about debt scope.

3.2 Establish a perfect evaluation system, and select appropriate assessment methods

Appropriate evaluation methods usually include tow systems: One is the basic system which includes financial analysis, industry analysis, operating conditions analysis. Analysis of the financial system contribute to the understanding of the financial situation between the two sides, Industry analysis system, can make the bidder understand the external environment, as well as the status of industry trends. Through the analysis of operating conditions can understand the existing problems the operation, and provide the basis for integration. On this basis, enterprises can avoid this risk. Second is the evaluation system. There are many methods of the evaluation system, just as book value, market value, liquidation value, discounted cash flow and so on. Different valuation methods will lead to different price, so firms should select a better method in accordance with their own motive.

3.3 Flexible choice of payment methods

Reasonable arrangements for the payment method and financial cost reducing are related to the payment method in

which cash payment face the most pressure. M & A business can combine their own available resources, diluted earnings per share and stock price volatility, changes in the shareholding structure in order to make their payment as combinations of cash, debt and stock, so that it can meet the need between two sides. For example, M&A takes two-tier payment method, for the first, adopt cash method while mixed method is used when the second step. This payment, on the one hand, because of the size of the transaction, the buyer paid cash consideration of a limited capacity, should maintain a more reasonable capital structure to reduce the enormous pressure on the loan, on the other hand, bidder can induce shareholders of target firm to make sell decision as soon as possible, and then they can reach the goal of obtaining control of the business.

3.4 To strengthen the post-merger integration

3.4.1 Strengthening financial control, financial integration of human resources, financial institutions and functions of the organization

For example, mergers and acquisitions business was to appoint Chief Financial Officer, Chief Financial Officer has clear responsibility and authority, they play the organization and monitoring role on the M & A business from day-to-day financial activities, and enjoy the decision-making power on a major event involved in the whole enterprise; implementing the structure of the M & A Adjust, the allocation of resources, a significant investment, technology development and other major decision-making to the budget of the corporate mergers and acquisitions, monitoring and controlling various types of the budget implementation, and audit its financial reporting; being responsible for personnel management business of their own financial accounting; reporting the M & A's assets operation and financial position on a regular basis. At the same time, when the acquisition is completed, financial institutions and the functions should be improved according to the specific circumstances of their organizations, including financial accounting systems, internal control systems, investment and financing system to make it more responsive to the needs of both mergers and acquisitions, and to establish a unified Financial information platform, so that management can be faster, more accurate and more comprehensive access to all types of financial information in order to meet the needs of decision-making.

3.4.2 Integration of financial management

Financial management objective is the starting point and end point of financial working, its determination directly impact on the theory of the financial system, and will determine the choice of a variety of financial decision-making. Upon completion of mergers and acquisitions, firms should make a clear objective of financial management based on the financial side of target firms.

3.4.3 Integration of asset and liabilities

In M & A business, debt of bidders may increase because of taking over the acquisition's debt, or adopt financial method just as loans and bonds issue. If capital structure is irrational, and financial situation also become deterioration. So the balance of integration aiming at improving the financial situation and enhance the solvency of enterprises.

3.5 To enhance the risk awareness of management of enterprise, establish and improve financial risk prediction and monitoring system

To raise the risk awareness of management of the business will guard against financial risks of mergers and acquisitions from the source. In addition, establish its own enterprise financial risk prevention and control system within the enterprise, to strengthen business-to-risk M & A forecast is one of the key areas of the establishment of early warning mechanism for risk prevention system. M & A business as a better way with the unique advantages of the expansion of the scale, rapid market strategy, the socio-economic restructuring and resources optimization to become a topic of concern, the financial risk arising from the merger is also a deep wide range of people discussion of the field. As the market matures, I think M & A activity will be more thoroughly researched on mergers and acquisitions of financial risk issues will be further deepened, to achieve a real and practical application of theory to guide practice.

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