

Application and Risk Analysis of Gambling Agreement in Business Acquisition —Take Huichuan Technology for Example

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ABSTRACT

With China's economic growth, capital markets continue to grow, enterprises to seek financing channels and ways of development, mergers and acquisitions between enterprises frequently, with the frequent application of this means, its shortcomings are increasingly exposed. Due to information asymmetry, high valuation of M & A target, M & A risk is increasing, in order to deal with and prevent M & A risk, the gambling agreement came into being in mergers and acquisitions. VAM itself as a risk management tool, there are also risks. This paper takes Huichuan technology to bet agreement to reduce the risk of mergers and acquisitions, and summarizes the enlightenment obtained, hoping to provide some reference for mergers and acquisitions in the market.

Keyword: *Gambling agreement, Business acquisition, Risk response*

1. FOREWORD

With the intensification of market competition, the survival of enterprises is facing a severe test. Enterprises rely on their own scale to enter the new market is more and more unsuitable for the new enterprise situation. Instead, mergers and acquisitions, through mergers and acquisitions, the scale of enterprises can be rapidly expanded, and obtain market control, while seizing resources. Therefore, M & A of enterprises will continue to grow in the future. Due to the problems of information asymmetry and high premium, there are risks in mergers and acquisitions. In order to deal with this risk, the gambling agreement came into being. Gambling agreements are more and more widely used in enterprises. However, according to wind data, between 2015 and 2018, there were more than 3600 gambling mergers and acquisitions in China's A shares, but only 80% of them were successful. It shows that there are risks in the application of gambling agreement in enterprises. Under this background, this paper analyzes the risk of the application of gambling agreement in enterprise mergers and acquisitions, studies the response of Huichuan technology to the risk of gambling, and improves the application of gambling agreement in enterprise mergers and acquisitions

2. LITERATURE REVIEW

The earliest theoretical review of VAM comes from abroad. It is believed that VAM is mainly based on the theory of real options and information asymmetry. Trigeorgis (1996) was the first scholar to apply the theory of real options to the gambling agreement. Similarly, Tang and Liu (2006) studied the gambling cases of Mengniu and Morgan Stanley, and also studied the gambling agreement from the theory of real options. Kohers, Ninon (2000), Frankel (2001), ReuerJJJ, Shenkar (2004) and other scholars from the theory of asymmetric information on the application of gambling agreements in mergers and acquisitions, that asymmetric information on mergers and acquisitions have a very direct impact. Domestic research on the theory of gambling agreement has also made new progress. Yue Xiaoli (2017) and Wang Qing (2019) take blue cursor company and Zhang Interest Technology as examples, respectively. They believe that the gambling agreement should be consistent with the purpose of mergers and acquisitions, and must strictly control the risk generated under the condition of asymmetric information. Taking the use of gambling agreement in multiple mergers and acquisitions as an example, it emphasizes that light assets improve the probability of successful gambling.

3. HUICHUAN TECHNOLOGY AND BEST'S GAMBLING PROCESS

3.1. Brief Introduction of Huichuan Technology on the Subject of Gambling Mergers And Acquisitions

3.1.1. Introduction and Development Process of Huichuan Technology Company

Huichuan Technology Co., Ltd. was established in April 2003 and successfully listed on the GEM of Shenzhen Stock Exchange in 2010 (stock abbreviation : Huichuan Technology, stock code : 300124). After more than ten years of development, the company has developed from a single inverter supplier to a high-tech company focusing on industrial automation and new energy product development, production and sales. It has become the leading enterprise of domestic industrial control. In January 2012, Forbes China 's most potential listed companies, ranked first. In 2019, the company achieved sales revenue of CNY 7.39 billion, an increase of 25.81 % year-on-year, and the net profit attributable to shareholders of listed companies was CNY 952 million. Although Huichuan technology has developed rapidly in recent years, its international business is mainly concentrated in Southeast Asia and India, and the market share of other international markets is very low. Therefore, it is an important strategy for Huichuan technology to actively carry out international business and improve its market share in other international areas in recent years. The inverter products produced by Huichuan technology mainly supply the company's general automation business and elevator integration business, and the company's important source of income. At the beginning of its establishment, Huichuan technology is the starting point for elevator parts to carry out the company's business. After more than ten years of development, the elevator integration business has become one of the important performance growth points of the company. Between 2015 and 2018, although the share of revenue from elevator integration business declined, it remained above 20 per cent, an important part of the company 's business.

3.1.2. Brief Introduction of BEST

Shanghai Best Electric Company was established in 2003, as long as engaged in the production of elevator accessories. In the field of elevator parts production in China, the market share of many products of Best is in the forefront of the market, and the market share of human-machine interface products ranks first in the industry. By the end of 2018, Best 's annual revenue reached 2.424 billion yuan, of which the annual revenue of human-machine interface products reached 1.158 billion yuan, accounting for 48.19 %. At present, Best

has established a complete all-round industrial service chain for elevator customers, which can provide a series of complete business chains from R & D and design to after-sales service. At the same time, Best has been in operation for many years, and has accumulated more high-quality customers, including well-known elevator manufacturers such as Otis, Tongli and Xunda. The company was listed on the ' Global Elevator Component Brand Impact TOP10 ' list in 2018.

3.2. Motivation and Feasibility Analysis of Gambling Mergers and Acquisitions

3.2.1. Huichuan Technology Gambling and Enough Best Motivation

Huichuan Technology Co., Ltd. is mainly engaged in industrial automation and new energy products related research and development, production and sales of high and new technologies. Products cover industrial automation, industrial robots, new energy vehicles, rail transit and industrial Internet solutions. According to financial disclosure, Huichuan Company 's revenue in the first half of 2019 was 2.719 billion, an increase of 9.96 % year on year, and its net profit was 3.99 billion, a decrease of 19.67 % year on year. After deducting non-recurring gains and losses, the net profit was 3.44 billion, a decrease of 24.88 % year on year. It is not difficult to find that although Huichuan Technology has increased revenue, its net profit acquisition has declined. In fact, the industrial control automation industry in which Huichuan Technology is located has not increased since its recovery in 2016 and before the fourth quarter of 2018.

Buying Best can be said to be a strategic merger for Huichuan Technology, not a simple financial merger. There are not only strong synergies and complementarities between listed companies and target companies in terms of products, technology, customers, market, manufacturing and management, but also Huichuan technology can obtain the strong competitiveness of the target company in foreign brands and further expand overseas markets after acquiring the target company, which is similar to the development strategy of Huichuan technology in recent years. At the same time, Huichuan technology can also benefit from the technological innovation and product development advantages of the target company after acquiring the target company.

3.2.2. Feasibility Analysis of Best 's Acquisition

Best belongs to the elevator parts manufacturing industry, and the market competition among the same industries is very fierce. To achieve rapid development of enterprises, it requires a lot of financial support and financing. Facing this problem. By merging into a

subsidiary of Huichuan Technology, Best can obtain a large amount of capital injection and provide sufficient financial support for the subsequent development of enterprises. At the same time, attached to large enterprises, they have relatively more advantages in the face of competition among the same industries. In addition, due to the uncertainty of future development, the development of enterprises is faced with great risks. After becoming a subsidiary of Huichuan Technology, Huichuan Technology also bears corresponding risks in obtaining corresponding benefits, while the risks borne by Best are relatively reduced. Therefore, it is feasible for Best to be merged.

3.3. Huichuan Technology in Mergers and Acquisitions in the Use of Gambling Agreement Process

3.3.1. A brief Introduction to the Process of Acquiring Best

Reference Figure 1

3.3.2. Introduction to the Design of Gambling Terms

In this gambling M & A, the book value of Best ' s owner ' s rights and interests is 46.7766 million yuan, while the evaluation value of this transaction is 24.9389.01 million yuan, and the premium rate is as high as 443 % . So Huichuan technology signed a bet agreement on Best, to examine Best ' s future indicators. In this M & A transaction, Huichuan Technology signed a gambling agreement with Best containing three commitments. The two sides of the M & A combine property indicators with non-financial indicators, and innovatively use the gross interest rate of Best's transnational business in the next three years, the on-time delivery rate of major supporting centers and the turnover rate of core personnel as the gambling indicators. The annual compound growth rate of cross-border business gross profit is based on Best ' s gross profit of 369.6154 million yuan in 2018. When the annual compound growth rate of industrial elevator production is greater than or equal to-7 % , the cumulative gross profit of the three years from 2019 to 2021 is not less than 122.34730 million yuan. When the annual compound growth rate of industrial elevator production is greater than or equal to-20 % less than-7 % , the cumulative gross profit of the three years from 2019 to 2021 is not less than 11.88461 million yuan.

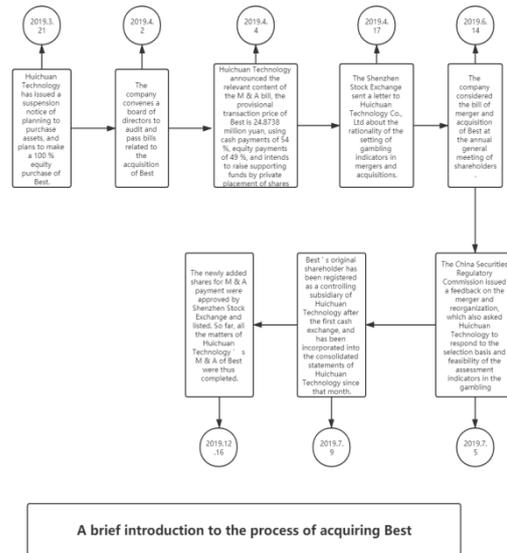


Figure 1 A brief Introduction To The Process Of Acquiring Best

3.3.3. Performance Compensation Design

According to the M & A agreement, when Best failed to complete the terms of the assessment commitments, Best ' s original shareholders need to Huichuan technology performance compensation. When the annual compound growth rate of industry elevator production (R) is greater than or equal to-7 % , the compensation amount = (cumulative promised gross profit-cumulative actual gross profit) cumulative promised gross profit × total price of underlying assets × K (K = 1) ; R = 1 when R ≥ -12 % < 7 % ; When R ≥ -20 % < -12 % , R = 0.6. When the on-time delivery rate of the large supporting center does not reach the promised performance, Best needs to pay Huichuan 20 million in technical compensation. When the core staff turnover rate (Q) is greater than or equal to 10 % less than 20 % , the compensation amount is 10 million ; When Q ≥ 20 % or less than 30 % , compensation is 40 million. When Q is greater than 30 % , the compensation amount is 90 million.

In addition to the performance compensation arrangement, in order to ensure that the compensation obligor of BEST can perform the compensation obligation as agreed when triggering the performance compensation, the acquirer also sets a stock lock-in period for Huichuan Technology shares acquired by BEST in this acquisition, and makes an agreement on the payment method of performance compensation. When performing the compensation obligation, the original shareholders of Best should give priority to the shares held by Huichuan Technology. If its shares in Huichuan Technology are not sufficient to compensate for the actual amount of compensation to be performed, Huichuan Technology will be compensated in cash.

4. RISK ANALYSIS OF HUICHUAN TECHNOLOGY ON BEST

4.1. The Valuation Risk in Enterprise M & A

Valuation is the most basic premise in enterprise M & A, and there are many valuation methods. At present, China ' s enterprises in mergers and acquisitions using more valuation methods are income method, cost method, market method. In order to avoid the defects of single valuation method in the process of mergers and acquisitions, improve the rationality of the underlying assets and reduce the risk of valuation, Huichuan technology selects the income method and the cost method to evaluate Best according to the characteristics of the industry and market information. The enterprise valuation risk can be reflected by the premium rate. The higher the premium is, the greater the risk that the target enterprise cannot fulfill its commitment performance is. In this Huichuan technology merger and acquisition of Best, the premium rate is as high as 443 %. Although Huichuan Technology strictly abides by the relevant provisions in its assessment of Best, there may still be discrepancies between the assessment value and the actual value because the income method is based on future projections and is assessed on a series of assumptions. Especially when the future macroeconomic fluctuations and major changes in industry policies occur, Best ' s profitability may not reach the level predicted by the assessment, which may lead to the risk of large differences between Best ' s valuation and actual value.

4.2. Performance Goal Setting Risk

In the design of gambling agreement, the setting of performance target needs to be set in a reasonable range according to the actual situation. In M & A transactions, if the market situation and the underlying enterprises are not fully understood, it may be wrong to estimate the profitability of enterprises in the future. In general, in order to obtain higher M & A valuation and promote the successful completion of M & A, the target enterprises usually accept the relatively strict performance goals proposed by the acquirers. In this case, there will be the risk of unreasonable performance goals and deviating from the actual situation of the target enterprise. If the performance target design is too low, although it is easier to complete the performance target on the surface, it does not play an incentive role for the management and there is no performance pressure, which may lead to a decline in the operating capacity of the target enterprises during the gambling period. If the performance goal is too high, it will play a certain incentive role for the management. However, in order to achieve the promised performance, it may over-develop enterprise resources, resulting in resource depletion, and also damaging the sustainable business ability of both

sides. Therefore, when setting the performance target in the gambling agreement, if Huichuan technology does not fully understand the actual operation of the target enterprise, there is an unreasonable risk of setting the performance target, which brings risks to both parties.

4.3. Risk of Core Personnel Mobility

Human resources as the most prone to change in the enterprise resources, may be due to various internal and external factors of human resources flow, especially in the enterprise management personnel. Therefore, the management of the target enterprise also has the risk of personnel flow. In this M & A, Best, as a high-tech industry, the scientific research knowledge and R & D technology mastered by the core team are one of the most important productivity. In the elevator parts industry, the competition among peers is very fierce, and the demand for relevant scientific research talents in the industry is also fierce. If there is a large-scale flow of personnel in the core team during the M & A process, such as turnover and job-hopping, it will have a very significant impact on the operation and development of Best. At the same time, these personnel are also management personnel, and these personnel changes after the M & A will greatly affect the stability of the company's development.

5. COUNTMEASURE ANALYSIS

VAM is essentially a kind of buy-in option based on the future operation of the underlying enterprise, and it must have certain risks in its application. Although China ' s current M & A transactions are widely used in gambling agreements, there are still many M & A transactions ended in gambling failure. This paper studies and analyzes the risk prevention measures taken by Huichuan Technology in the merger and acquisition of Best, and puts forward some suggestions to improve the application of gambling agreement in enterprise merger and acquisition from the above research on gambling agreement.

5.1. Coping with the Valuation Risk of M & A

Before the gambling agreement and mergers and acquisitions, it is necessary to analyze the macro market situation and market development, and try to find the M & A party that fits the market development and its own current development. Mergers and acquisitions can use the " five forces model " analysis method to analyze the external environment faced by enterprises in detail, find the bargaining power of external suppliers and customers, find the latest entrants in the industry and the threat of the latest development products, but also to analyze the competition between competitors in the industry. On this basis, the reasonable valuation of the subject matter can be carried out. Self-owned funds,

together with appropriate bank loans and reasonable proportion of equity payment, reduce the capital liquidity risk brought by the payment of M & A consideration to the maximum extent, and alleviate the financial pressure brought by high premiums to the future business development of enterprises.

5.2. Addressing Performance Goal Setting Risks

In the design of the gambling agreement, in order to prevent the failure of the gambling agreement and better reflect the business performance of the enterprise, the M & A parties can learn from international experience, and increase the diversity and flexibility of trigger conditions according to the growth rate of enterprise development in the current period ; Therefore, when the gambling agreement establishes the performance goal, the primary consideration factor should be the performance goal rationality, the performance goal must conform to the target enterprise actual management ability. Secondly, it should be noted whether the setting of this goal is conducive to stimulating the enthusiasm of the management of the target enterprise.

5.3. Coping with the Risk of Core Personnel Mobility

Since the target company ' s executive team is more aware of the company ' s operating conditions and development prospects, even after mergers and acquisitions, the management activities of the target company in the future period still need the original management personnel to be responsible. If the management of the underlying company is not constrained, there may be management myopia, turnover and other risks after the merger. Therefore, in the gambling agreement signed by the two sides of the M & A, the M & A party can specifically choose the turnover rate of core personnel as the gambling indicator. Such setting limits the behavior of the target core staff after M & A, to some extent, to ensure the stability of the company ' s core staff during the gambling period, and effectively prevent the risk of management behavior after M & A.

6. CONCLUSION

Taking Huichuan M & A case as an example, this paper studies the application of gambling agreement in M & A of listed companies, analyzes the problems existing in the application of gambling agreement and its impact by using the relevant theories of gambling agreement, predicts the future gambling results through the discussion of the content of gambling agreement, and puts forward relevant suggestions.

Due to the complexity and high risk of M & A

transactions, Huichuan M & A is based on its own development strategy. Select the appropriate object of mergers and acquisitions, and the underlying assets were investigated, more fully identify the risk of mergers and acquisitions, In M & A, the underlying assets can be reasonably valued, and appropriate transaction structure and payment methods are designed. However, the final results have not yet been presented, success or failure can only be predicted through relevant content.

Through the study of Huichuan ' s gambling content, we can still get some inspiration, and provide some reference for other enterprises to carry out gambling mergers and acquisitions. Enterprises in M & A transactions, should also do the following aspects of work, in order to make the gambling agreement in the prevention and control of M & A risk play a greater role. First, do a good job of due diligence before M & A, establish and improve risk assessment and response mechanisms, and do a good job of risk identification before M & A and resource integration after M & A. Second, do a good job in the feasibility study of mergers and acquisitions, improve their ability to deal with risks and mergers and acquisitions. Signing a gambling agreement is only a part of enterprises to deal with the risk of mergers and acquisitions, only with such ability to achieve the desired purpose of mergers and acquisitions. Third, the construction of market-oriented trading mechanism includes pricing mechanism and gambling model, adopts scientific valuation methods, carefully collects forecast parameters, and reasonably designs gambling agreement clauses. By designing the terms of gambling to retain and motivate management, to promote the interests of both sides, so that mergers and acquisitions to maximize synergies is particularly important. In summary, the gambling agreement has played a certain role in dealing with the risk of mergers and acquisitions, the use of good gambling mechanism can make both sides to achieve a win-win situation, resulting in greater synergies. But the option characteristics and complexity of the gambling agreement itself will also bring certain risks, both sides in the use of mergers and acquisitions to weigh the pros and cons.

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