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The research of Chinese enterprise management buy-out (MBO) financing problem

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Abstract –In recent years, MBO, which is considered as one of the effective ways for state-owned capital to exit from the field of competitive, has been practiced constantly in the operation of the capital markets, But our management buy-out in financing process still exists a lot of problems. Difficulties in financing restrict the healthy development of the management buy-out (MBO), and the defects of financing way is the important reason caused financing difficulties. This paper through contrasting the management buy-out in financing ways at home and abroad and analyzing the various problems in our country to propose the solution measures, in order to promote the healthy development of the securities markets.

Keywords –MBO, Financing way, Financing channel

1. Introduction

Management buy-out (MBO) is M&A activities which the target companies Management through using lending finance purchase the company's shares, thereby changing the company ownership structure or control structure, and then through the reorganization of the target company realizing the expected benefit.

MBO as one kind of leveraged buyouts requires a large amount of funds in the implementation process, which is mainly financed by lending facilities. MBO funding sources are generally divided into two parts: one is the internal funds, namely provided by management itself. This part of funds is small proportion, about account for roughly 10% of the purchase funds. One is external funds, namely debt financing and equity financing. In normal circumstances, acquisition for equity or funds of the target company requires a lot of money, so the external funds accounted for most of the acquisition of funds. If the external financing couldn't be solved well, it will directly restrict the success of MBO. In this paper we will analyze the problems exist in MBO financing way.

2. Chinese and foreign financing way contrast

2.1 Foreign MBO financing way

It has a variety of financing way for Western countries implying MBO, including the management equity fund financing, Bank and non-bank financial institutions loan financing, issuing bonds and stocks financing way. The most important is the debt financing, also includes a portion of the equity financing, which is mainly provided by venture capitalists or MBO Funds.

Debt financing including senior debt financing and subordinated debt financing. Senior debt in foreign MBO financing accounted for the largest proportion, 50% - 60%, it put the target company assets and equity as mortgages. Priority repaid from operating cash flows and income from the sale of assets of the target company, so its gains and risk are both the lowest. It mainly provided by commercial banks. Subordinated debt is the most abundant species in MBO debt financing, it Mainly through private placement (for pension funds, insurance companies, investment Banks, etc.) and offering high yield risk bonds publicly(that is, junk bonds) to raise, financing proportion inferior to the underlying bonds, accounting for 20% - 30% of the total amount of financing.

Equity financing mainly includes issue stock and equity agreement, which accounted for 10%- 20% of the total amount of financing in general. In foreign country, the main object of external equity financing is strategic investors; they have a certain proportion of company shares, as investors and issuer double identity.

2.2 Chinese MBO financing way

Although foreign MBO financing way is numerous, due to the limitations of our of legislation economic and capital market, MBO financing channel in our country is narrow, financing way is single. The main reason lies in:

1. In the debt financing, foreign can loans through the banks or non-bank financial institutions. But in our country, because of the regulation of General Rules on Loans, loans obtained from financial institutions shall not be used for equity investment. So this kind of financing way is not legal. For example YueMei company realized MBO through the equity pledge loan way, that is to say, management uses the shares of target company which been acquired in future as collateral to apply for loan from the bank. Although this form of financing is more in line with the standard of leveraged buyout, there exists legal risks, it can't be popularized in our country. In term of issuance of bonds, Chinese bond market is underdeveloped, examination and approval procedures are fairly strict. Profitability of the subject, liabilities scale and use of funds, there are stringent restrictions, management does not have the main qualifications to issue the bond, so it is impossible in our country to issue junk bonds.

2. In the equity financing, in view of our current stock issued regulations, company established by the management is not qualified to issue stock. China is also lack of strategic investors involving in equity.

3. Defect caused by Chinese single MBO financing way

Because single MBO financing way causes financing difficulties, so in the most MBO cases, acquirers take some concealed and indirect financing ways to alleviate the huge capital pressure, which causing the management illegal financing behavior. Such as divert enterprise assets or credit illegal loans, manipulation of the accounting information, connected transaction and so on, in addition, the single mode of financing can also lead to the listed companies' MBO financing structure unreasonable.

3.1 divert enterprise assets or credit illegal loans

Due to the laws prohibit bank loans using for equity investment, At the same time the laws also banned enterprise take equity or assets as mortgage to bank for guaranteeing, divert accommodating money to individuals, it also prohibits individual put stock as pledge to bank for loan purchase. But it's very difficult raising a large sum of funds only by management legal free funds. At this time, if the management want to complete the MBO, only through illegal loans. And the reason is because our country's limitation in financing channels, and single mode.

3.2 manipulate accounting information

It is difficult for management to raise enough money only by normal channels; they will be as far as possible with asymmetric information to manipulate report profits, thus reducing their equity purchase price paid. In the process of the implementation of MBO, management uses the means of interception, transformation, occultation embezzling a lot of state-owned assets, causing the enterprise carrying net worth far less than the actual net assets. Or the management uses the right of accounting policy choice, through the dispensation or hidden profit way to expand enterprise losses, and then by using the book losses make the government transfers equity to management at a low price. This behavior seriously damages the interests of other stakeholders, and may even jeopardize the long-term development of the enterprise.

3.3 connected transaction

Related transactions are also a way for management raising funds, which is widespread in Chinese enterprises and listed companies. Most of Chinese MBO cases which had happened had connected transaction, such as YueMei, Donating water colonization, Shenzhen party; Fusu companies all had connected transaction with big shareholder before they executed MBO. Related transactions will make assets or funds of the enterprise outflow seriously, affecting the long-term development of the enterprise.

3.4 Single financing mode led to Chinese listed companies' MBO financing structure unreasonable

Viewing from the public disclosure of information. we can find in the financing structure of listed companies, personal finance is prominent, while external equity financing is scanty, which led to companies' debt ratio and financial risk increasing. To make matters worse, in our country, MBO financing period is relatively short, only two years. Huge repayment pressure make enterprises implied MBO easily carrying out short-term behavior, which causing financial risk and moral hazard at last.

4. Put forward some Suggestions in view of above problems

The root reason why our MBO financing caused such problems is the underdeveloped capital markets. So we should vigorously promote the improvement of financial markets, securities institutions, finance companies and investment banks and other financial institutions, the innovation of financial instruments and system, providing a good MBO financing market environment.This is the fundamental to guarantee the development of MBO in our country reasonable.

4.1 broaden MBO financing channels

Liberal financial legal system is essential for management buyout implies smoothly, so improving financial legal system and promoting healthy development of the financial market is very important. The implementation of MB0 requires adequate financial support, but Chinese financial system results commercial bank is unable to play an important role in the management buyout, so how to bridge the huge funding gap has become the key issue. At present the feasible way is to provide financial support by the securities companies. Because securities companies, trust and investment companies are the major institutions engaged in investment banking business in our country. These institutions have professional talents and capital operation experience and ability, they can design acquisition scheme according to the enterprise management status. And as the traditional field competition is becoming increasingly fierce, management buy-out also provide a better profit opportunity for securities firms.

4.2 encourage the innovation of financing way such as "utilize entrepreneurs' value of insurance contract as mortgage"

Financing mechanism is the important driving force to promote economic growth. But relative to western countries, Chinese listed companies MBO financing way is so single, mainly reflects in the following aspects: first, it lacks of credit loans, junk bonds and other financing tools in the debt financing; Secondly, we can't issue preferred stock in the equity financing; finally, it lacks of corresponding conversion tools between equity financing and debt financing. In order to conduct MBO smoothly, it is necessary to speed up the reform of financial system and encourage MBO financing innovation. "utilize entrepreneurs value of insurance contract as mortgage" can provide a new idea to resolve the financing problems during MBO process.

" Utilize entrepreneurs value of insurance contract as mortgage" needs three steps to complete: first management hire assessment institution to assess the value of its entrepreneurs to form an entrepreneurs valuation report, and then apply for insurance on the basic of entrepreneurs value evaluation report, sign entrepreneurs value insurance contract with insurance institution; finally, extend credit using the entrepreneurs value of insurance contracts as mortgage. This kind of bond financing uses entrepreneurs 'own value as mortgage, which can constraint management business behavior. Once management is unable to repay maturing loans, their reputation is bound to suffer serious damage, the value of entrepreneurs will depreciate by heavy losses. And the use of debt leverage will also constrain the opportunism behavior of management.

4.3 perfecting relevant laws and regulations systems

If one kind of commercial operation mode always wander the edge of the law, then the business model will be very difficult to truly become a stable path of reform. In order to make MBO become an effective method in the reform of state-owned enterprises in China, the modification of existing laws is undoubtedly imperative. Although our country has several laws appear to relate to the constraints listed MBO behavior management, such as "company law", "securities law", "The measure for the administration and acquisition of listed companies", "The interim regulations for issuing and trading of stock", we have no specific laws and regulations, so we cannot supervise the MBO of listed companies effectively. Therefore, it is necessary to issue laws and regulations about MBO specifically, which will clear the implementation of MBO legitimacy. At the same time, gradually perfecting and refining the laws of securities market supervision regulation, to form the coherent, operable legal system.

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