Study on Financing Risk Evaluation of Foreign Private Equity Fund

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Abstract: Private equity financing has become an important means of financing for modern enterprises, which is conducive to the maturity and growth of enterprises and promotes industrial development. However, due to the relatively late development of the securities market and the imperfect management and supervision systems, the related risks brought by this financing method deserve the high attention of enterprises. This article sorts out the risks in the private equity financing process and proposes corresponding solutions.

1. Introduction

Private equity financing is a corporate financing behavior in which a company obtains capital investment from a private equity fund manager by selling part of its equity. At present, private equity financing has become an important means of corporate financing in my country. However, with the further development of private equity financing, the drawbacks of private equity financing deserve the high attention of enterprises.

2. Introduction to Private Equity Financing Process

The manager of a private equity investment fund shall establish an evaluation and supervision system for risk management, strengthen the supervision and feedback on risk management activities, and adjust the risk management system according to the feedback, relevant laws and regulations, and changes in the internal and external environment.

The improvement of the regulatory system provides a clearer idea for the risk management of funds, but its continuous enrichment process also brings some compliance risks to the industry. Private equity investment funds have high requirements for managers' professional skills and risk management capabilities. However, due to the lack of strict industry access and regulatory standards in my country's private equity industry for a long time, the professional capabilities of registered managers are uneven. Risk management capabilities vary greatly, and some managers lack professional capabilities. Due to the difference in knowledge and moral level of managers, the effects of risk management are quite different. There are many chaos in the market such as blind pursuit of high returns, blind conservative investment, and concealment of project status. In recent years, regulatory regulations and self-discipline norms have been gradually improved, especially since the publication of the "Announcement on the Submission of Special Legal Opinions by Private
Fund Managers under Abnormal Business Situations. China Foundation Association is gradually clearing up abnormal operations and private placements that do not meet the registration requirements. Fund manager qualifications, and the phenomenon of differentiated risk management levels is gradually improving.

In 2014, the China Securities Regulatory Commission promulgated the "Interim Measures for the Supervision and Administration of Private Investment Funds", and in January 2021 the China Securities Regulatory Commission promulgated "Several Regulations on Strengthening the Supervision of Private Investment Funds", which clarified the overall trend of increased supervision and provided support for various fund companies. Risk management behavior provides a more rigorous basis for implementation and evaluation; In addition, the "Securities Law", "Securities Investment Fund Law", "Interim Measures for the Administration of Venture Capital Enterprises", "Administrative Measures for the Suitability of Securities and Futures Investors" and other regulations on private equity investment funds and the "Private Fund Filing Instructions" and other implementation rules have also enriched the supervision system of private funds. While providing unified rules for funds, they also provide a more complete evaluation system for the risk management behavior of fund managers.

At present, there is no unified standard for evaluating the risk management of real estate private equity investment funds in the Chinese market. Based on the "Interim Measures for the Supervision and Administration of Private Investment Funds" and other regulatory manuals and market practices promulgated by the China Securities Regulatory Commission in 2014, the following risk management evaluation indicators can be used. To evaluate the risk management activities of real estate private equity investment funds. (Table 1 Risk management evaluation indicators).

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Legality

Perfection

Enforceability and effectiveness

Scientific and rigorous business operation process

The functions of each department of the fund manager are independent of each other

Separation of fund property from company property and other property

Adjust risk management behaviors in a timely manner according to changes in the internal and external environment
3. Reasons for risks in private equity financing

The securities market developed relatively late, and its management was not perfect. In particular, there were defects in the supervision system of private equity. Private equity fund managers took advantage of these system defects to disrupt the efficiency and fairness of the securities market. As a result, the risks of private equity funds are gradually revealed.

3.1. Political risks

The political environment of a country is determined by the economic foundation, but changes in the political environment will inevitably affect the economic operation and even pose political risks in the market. Investors are often easily influenced by political factors and misjudgment about future investment returns, resulting in violent fluctuations in securities market prices, and finally affecting fund investment.

3.2. Policy risk

In the operation of the national economy, the government usually uses different control methods according to the macroeconomic development goals, including fiscal policy, tax policy, monetary policy, etc.

3.3. Legal risks

The main legal risk of private equity funds is due to the fact that my country has not explicitly given its legal status for the time being. Various non-standard legal provisions also restrict the development of private equity funds, and the legitimate rights and interests of investors cannot be effectively protected by law.

3.4. Credit risks

The inherent feature of private equity funds is concealment. Generally, private equity funds do not have strict disclosure restrictions, which can easily lead to information asymmetry between fund managers and qualified investors, which is not conducive to the protection of the interests of fund holders, especially funds. If the manager does not abide by the partnership agreement, it is very easy for qualified investors to suffer losses.

3.5. Operational risk

In view of the lack of government supervision of private equity funds and the imperfection of its own information disclosure system, related transactions, non-compliant transactions and damage to the rights and interests of partners will inevitably be involved in the process of private equity investment and financing. Many private equity fund management companies in the market have imperfect isolation systems and internal control systems, and their internal practitioners are also prone to professional conduct risks and moral hazard.

4. Key risks and risk solutions

Through the actual operation process of private equity financing, the author summarizes the following risks, and expounds the causes, adverse effects and solutions of the risks.
4.1. The main causes and solutions of financing failure risk

4.1.1. Inconsistent views during business negotiation

Before an enterprise conducts financing activities, it should conduct a comprehensive analysis of the financing feasibility and rationally treat the equity financing behavior to achieve reasonable expectations. Two factors determine a reasonable enterprise valuation: one is the value of the enterprise, and the other is the price of the enterprise.

4.1.2. Substantial legal obstacles exist

Before financing, it should be familiar with relevant equity investment and financing laws and regulations, and analyze in advance whether it violates relevant laws and regulations. Don't set too many delivery conditions.

4.1.3. Government approval process is difficult to pass

Enterprises should maintain good relations with government departments and should be familiar with the government's supervision of the industry in which the company operates and avoid its risks. Contingency plans should also be prepared in advance to deal with difficult and time-consuming government approvals, especially those involving special industries and franchising.

4.1.4. The investment and financing parties themselves lack due mutual trust

Financing is like finding a partner. A good communication atmosphere and communication skills are more conducive to the negotiation between the two parties. It needs to establish a reasonable negotiation mechanism, clarify the scope of authority and responsibilities of the negotiating team members, and coordinate their respective work. According to the progress of the work, it is recommended to establish a timetable to save time.

4.2. The main causes and solutions of trade secret leakage

4.2.1. Pre-investment due diligence results in trade secret disclosure

In the process of enterprise investment and financing, the project investor is bound to have a comprehensive and detailed understanding of the financier and due diligence, and may also involve the financier's business secrets. In order to better protect the financing company, the two parties should sign a confidentiality agreement. Both parties should have the obligation to keep the whole process of the investment and financing activities confidential. The financing company should stipulate the terms of the confidentiality contract, clarify the scope and validity period of the confidentiality contract and the formulation of reasonable and effective confidentiality measures.

4.2.2. Lack of effective restraint or failure to fulfill confidentiality agreements

First, due to the lack of confidentiality awareness of the financier, the investment and financing parties did not carry out relevant constraints on business secrets before negotiation and due diligence, or although they signed a confidentiality contract, the terms did not explain the breach of contract, resulting in inadequate performance. Second, the investor or the intermediary professional agency hired by the investor for the investment has not made a commercial confidentiality agreement, and there may be leaks. Solution: Provide confidential information in stages. It is recommended that the financing party allocate and provide information on financing companies
according to the investment and financing progress of both parties. In particular, the core content of the company and the confidential content of the company can be controlled to be disclosed in a small range. Try not to provide the business secrets and core data of the company before signing the confidentiality contract.

4.3. Major causes of default solutions

4.3.1. Inaccurate representations and warranties

Investor factors: There is no comprehensive and in-depth due diligence on the financing company, and it is impossible to accurately analyze the actual operation of the company and future industry development; Financing factors: The company maliciously failed to disclose real information for some reason or did not fully prepare for the financing before financing. Solution: Disclose company information truthfully and accurately, and hire a team of professional lawyers to participate if conditions permit. Especially when the terms of the investment agreement involve representations and warranties, the financier may consider limiting the effective scope of the representations and warranties, and strive to make the effective scope as small as possible, because the smaller the effective scope of the clause is, the higher the possibility of the financier defaulting will be reduced accordingly.

4.3.2. Failed to transfer shares on time

It is difficult for the financier to obtain the approval of the government and its regulatory authorities within the agreed time limit, and the substantive obstacles caused by laws and regulations have not been dealt with or cleared in time before investment and financing. Solution: Make sure the financing company perform the contract in a complete, orderly and on time. The financing company participating in the financing can arrange a reasonable timetable according to the content of the contract to help the company fully perform the contract.

4.3.3. Failed to achieve the promised target on time after the equity change

The financier fails to realize various commitments within a period of operation after the equity change, and the financing enterprise fails to achieve the established business objectives within the agreed period due to its own reasons. Solution: reduce the liability for breach of contract through effective measures. The first is to avoid the breach of contract caused by the disclosure as much as possible: especially because the investor is negligent and does not require the financier to disclose the part, the financier can be exempted from the liability for breach of contract; the second is to limit the amount of compensation as far as possible in the compensation clause of the investment contract.

4.4. The main causes and solutions of the difficulties after financing

4.4.1. Investors may have veto power

Generally speaking, in order to ensure that their rights and interests are not infringed and damaged, investors will require a veto power over major matters of the enterprise when investing, so as to realize the right to control the enterprise. For this reason, the financing enterprise should stipulate in the investment contract the scope of application of the investor's exercise of the one-vote veto: First, the exercise of the one-vote veto shall be premised on ensuring the normal operation of the enterprise without prejudice to the interests of both investors and financing parties.
Second, the scope of application of the one-vote veto power should be determined according to the proportion of equity held by the investor.

4.4.2. Directly involved in business management

After the investment is successfully completed, the investor will be required to directly participate in the daily operation and management of the enterprise during the actual operation process. Usually, the chief financial officer and the deputy general manager are assigned to be in charge of the business. The major decision-making of the enterprise and the use of major funds require joint decision-making power. Therefore, a reasonable deadlock resolution mechanism is needed. When there is a disagreement between the investment and financing parties due to the operation of the enterprise and relevant decisions, confrontation period often ensue. In order to ensure that the enterprise can still produce and operate normally in the future, sufficient time should be given for the investment and financing parties to conduct reasonable and effective discussions in order to reach a consensus.

4.5. The main reasons and solutions of the hidden trouble in listing

4.5.1. Contributions do not meet government regulatory requirements

Since the investment of equity investors does not meet the requirements of relevant government regulatory policies, the subject qualifications of the investors should be checked, and investors with certain creditworthiness should be selected; necessary due diligence should be carried out on the investors; private fund manager qualification and the manager company should be in a legal period of existence.

4.5.2. Investors' additional rights violate the "same share and same rights"

This is embodied in the requirement of different rights for the same shares when exercising voting rights. Generally, investors will request to obtain the corresponding rights by voting several times of the shares they hold. This is a violation of company law. The company law can restrict or reject the excessive demands of investors that violate the principle of "same shares, same rights". According to the terms of the investment agreement, if the financing company applies for listing, such additional powers will automatically become invalid; as for the veto power, it should correspond to the proportion of equity held by the investor, rather than being bound to the identity of the investor.

4.5.3. Gambling terms are not good for financiers

Investment institutions usually use VAM terms to restrict financing companies when investing in equity, and VAM terms often easily make the equity ratio and structure of financing companies uncertain. It is recommended that financing companies try to avoid signing VAM clauses with investors when conditions permit. Generally speaking, VAM terms are prone to adverse situations for financiers. If the appearance of the gambling clause cannot be avoided, two-way gambling should be selected. According to the relevant provisions of Chinese laws, enterprises should cancel all gambling mechanisms when applying for IPO.

5. Conclusion

The risks faced by private equity funds mainly include political risk, policy risk, legal risk, credit risk, operational risk, etc., which appear in one or several stages of fund raising, investment,
management and withdrawal respectively. They are related to each other and need to be paid attention to.

References