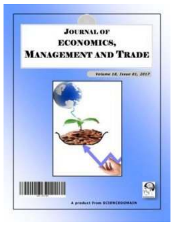

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Defense Strategies of Listed Companies under Hostile Takeover: A Case Study

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Authors' contributions

This work was carried out in collaboration between all authors. All authors read and approved the final manuscript.

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Case Study

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ABSTRACT

There are many brilliant, far-reaching and complex hostile takeover cases in China's capital market in recent years. Hostile acquisition has both pros and cons. On one hand, for the inefficient companies, it is an important external governance mechanism, which can solve the agency problem effectively. On the other hand, for the efficient corporates, it will damage the company structure, administration model, and corporate culture. This paper analyzes the hostile takeover of listed companies, the Mergers and Acquisitions (M&A) defense strategies and establishes a corporate anti-takeover system for listed companies through a specific case, which can help regulating takeover and the M&A defense of listed companies and promote the sustained steady development of the listed companies and capital market.

Keywords: Hostile takeover; ownership structure; mergers and acquisitions defense; corporate governance.

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1. INTRODUCTION

In June 2015, China went through a great volatility of capital market and Vanke's share slumped. Without the agreement of the Board of Vanke, Baoneng Group bought out a great amount of Vanke's floating stock in the secondary market. After seven times "banner-lifting" (means the shareholder who holds 5% or more share of a listed company must let the company, the securities regulatory authority under the State Council and Stock Exchange know about this), Baoneng Group eventually hold 24.29% of the share, which made it become the largest shareholder of Vanke. However, it invited a strong opposition from the management, especially Wang, the president of Vanke. On December 18, 2015, an emergency suspension of Vanke A was imposed for their major asset restructuring, which was to defense the hostile takeover form Baoneng Group [1]. "The battle for equity between Baoneng Group and Vanke" started.

In the capital market, M&A, transfers of control and so on are common means of capital operation. "The battle" is the most complex, the most brilliant, and the most influential M&A event ever of China's capital market, so it has attracted great attention form academic world and business. Vanke is an outstanding listed company in China with excellent operating performance, standardized corporate governance structure, and an excellent management team. Baoneng Group only spent about 30 billion RMB to became the largest shareholder of Vanke in nearly half a year, though the latter was a company with a value of 200 billion. We must think about how ownership structure, corporate governance, mergers and acquisitions affect the sustainable steady development of companies in another way. Therefore, this paper studies the hostile takeover and corporate anti-takeover strategies of listed companies, which aims to standardize the M&A defense of listed companies and promote the sustainable development of listed companies and capital markets.

2. LITERATURE REVIEW

Though Chinese scholars have not studied on the acquisition and anti-takeover research for a long time, they had some representative research findings. Luo [2] did research on how a company constructs its own anti-takeover system in the context of hostile takeovers; Huang [3] studied how to maintain the company and its shareholders' legal rights and interests during the process of anti-takeover; Wang [4] pointed out some effective measures when companies are facing hostile takeover; Lin [5] proposed how to establish and improve China's anti-takeover legal system; Wang [6] studied the significance of the anti-takeover system and started an empirical study on the value of anti-takeover system. Yang [7] gave some effective suggestions to companies on protecting the grassroots employees' legal rights and interests in the face of hostile takeovers.

Foreign scholars have studied acquisitions and anti-takeover strategies since long before, so the theoretical findings are abundant. The research findings of Dodd and Ruback [8], Bradley [9] showed that as an important external governance mechanism, acquisitions can effectively solve the inefficient companies' agency problem. In 1980, Fama published his article *Agency Problems and the Theory of the Firm*, which considered the stock market and acquisitions as the most effective external control mechanisms to solve the agency problem. Malatesta Walking [10] conducted empirical researches on poison pill strategies, and found that low-profited listed companies are more willing to use this kind of strategies. American scholar Richard Epstein [11] pointed out that during 1990s, anti-takeover laws in the United States tend to protect the management and allow companies to use the poison pill strategies to resist hostile takeovers.

In summary, scholars from all over the world paid great attention to company takeover and anti-takeover strategies and had a lot of findings. However, a case study on anti-takeover strategies is still lacking. This paper analyzes the case of "The battle for equity between Baoneng Group and Vanke" to show the rationality of hostile takeover and anti-takeover strategies, and constructs the Vanke anti-takeover strategies system which can help promote a stable development of listed companies and capital markets.

3. RESEARCH FOUNDATION OF COMPANY ACQUISITIONS AND TAKEOVER DEFENSE

3.1 Methods of Company Acquisitions

Refer to the Table 1, negotiated acquisitions, tender offer and centralized auction are main methods of company acquisitions in the capital market [12]. According to the attitude of both parties, acquisitions can be divided into friendly takeover and hostile takeover. Friendly acquisitions are negotiated and agreed upon by both parties. Hostile takeover refers to the bidding firm makes a takeover bid for the target company without the board of the target company's permission.

3.2 The Theoretical Basis of the Company's Anti-takeover

3.2.1 The market for corporate control theory

Henry G. Manner puts forward the theory of Market for Corporate Control. Corporate M&A is an important external governance mechanism for inefficient companies. However, in an open capital market, many efficient companies will be merged or acquired, too. Hostile takeover may have negative influence on the acquired company's governance structure, management model, business performance, and corporate culture [13]. At this point, the management should take anti-takeover measures to maintain the company's sustained and stable development.

3.2.2 Enterprise contract theory

According to Coase's enterprise contractual theory, a firm is a collection of contracts [14]. When a company pursues maximized interests of shareholders, it also needs to pay attention to its long-term development. If the hostile takeover does not meet the company's overall interest and long-term development, the management can take anti-takeover measures. In the 1980s, the industry in the United States made it clear that hostile takeover would undermine the original company's structure and development strategy to a certain extent [15].

Table 1. Methods and characteristics of company acquisitions

Acquisition methods	Definition	Characteristic	Nature	Typical case
Negotiated acquisitions	The acquirer, negotiates with the shareholders of the target company on the stock price and quantity outside the stock exchange, and acquires the shares of the target company.	The acquirer and the target company's controlling shareholder sign the share-purchase contract after friendly negotiations, which means the control transfers from the target company to the acquirer.	Friendly acquisitions	Greenland Group acquired Sunac China
Tender offer	The bidding company issues a notice of the acquisition to the target company. After the target company confirms, the bidding company can implement the acquisition.	The bidding company issue an offer to all shareholders in public so that all shareholders can obtain information equally and make their choice according to their own will.	Marketization acquisitions	Youku tookover Tudou.
Centralized auction	The bidding company continuously acquire floating share of the target company in the secondary market to hold controlling interest of the target company.	The bidding company does not communicate with the major shareholder of the target company or takes actions though their communication ends up with a failure.	Hostile acquisitions	Baoan Group acquired Yanzhong Industrial Company

Source: Administration of the Takeover of Listed Companies Procedures, Hollyhigh International Capital

4. TYPICAL CASE ANALYSIS OF THE BATTLE FOR EQUITY BETWEEN BAONENG GROUP AND VANKE

4.1 Case Description

Vanke is a representative of China's outstanding listed companies, with excellent business performance, sophisticated governance structure, pioneering management team. However, it is a typical ownership dispersion enterprise. Vanke's third quarterly report of 2015 showed that Vanke's largest shareholder - China Resources, only owns 15.23% of the share. Vanke's dispersal ownership structure makes it easy to be merged and acquired in the open capital market.

In June 2015, China's capital market broke out an unprecedented stock calamity. Unavoidably, Vanke's share price fell continuously. From July to December in 2015, Baoneng Group raised huge amount of money through the Universal Life Insurance and leverage. Without the consent of the Board of Vanke, Baoneng Group bought Vanke's floating shares in the secondary market continuously. On December 18, 2015, after seven times of "banner-lifting", Baoneng Group held 24.29% of the share and became the largest shareholder of Vanke [16], as shown in the Fig. 1. However, the management, whose president is Wang Shi, strongly opposed to the hostile takeover. At noon of that day, the Board of Vanke announced an emergency suspension for major asset restructuring, which prevented Baoneng Group from controlling Vanke.

On June 17, 2016, Vanke held a board meeting voting for introducing Shenzhen Metro as their "white knight". But China Resources voted against it, so the asset restructuring plan was not adopted. At the midnight of June 23th, Baoneng Group clearly opposed Vanke's asset restructuring and criticized Vanke's insider control problem.

In July 2016, the stock price plummeted and Vanke's stock resumed trading. Thus, Baoneng Group's plan of asset management was to be a failure. In order to change this situation, Baoneng increased its proportion of shareholdings to 25.4%, refer to Fig. 2. In August 2016, Evergrande Group "lifted banner" to Vanke. On November 29th, Evergrande Group's shareholding ratio of Vanke reached to 14.07%. On January 13th, 2017, China Resources sold its own 15.31% stake to the Shenzhen Metro Group with the price of 37.1 billion RMB. At this point, Vanke's ownership structure was reformed [17].

From August to December 2016, insurance funds continuously did hostile takeovers of high-quality blue chips, which affected the better development of the real economy. Soon, regulators were aware of the seriousness of this problem and promptly revised and improved the regulatory system. On December 3, 2016, Liu Shiyu, the Chairman of China Securities Regulatory Commission criticized the brutal-acquisitions in the public speech. On December 5th, the China Insurance Regulatory Commission (CIRC) issued a regulatory letter to stop Qian Hai Life Insurance Co., Ltd (QHL)'s universal insurance business. On February 24th, 2017, in view of the QHL had offered and dispersed false information and illegally used insurance funds, the CIRC cancelled Yao Zhenhua's job qualifications and prohibited him from engaging in insurance in the next decade [18]. On June 30, 2017, Vanke established a new board of directors enabling the management to strongly dominate the company; however, their control power got weakened.

4.2 The Inevitability and the Contingency of this Battle

4.2.1 The inevitability

With low interest rate, the investment income of fixed income assets is comparatively low, which means insurance funds must turn to equity investment for higher income; α QHL's premium increased quite fast, which resulted in high cost of financing and great premium pay pressure. So Baoneng Group had to invest high-quality blue chips [19]; Vanke's ownership dispersal structure is easy for Baoneng Group to take advantage of.

4.2.2 The contingency

Since the stock market crash from June 15th 2015, Vanke's stock price continued to fall, which was an opportunity for Baoneng Group to acquire Vanke with low cost. From July 10th 2015 to December 18th 2015, Baoneng Group bought Vanke shares at an average price of about 14 RMB, which means the cost for Baoneng Group to acquire Vanke reduced to a certain extent.

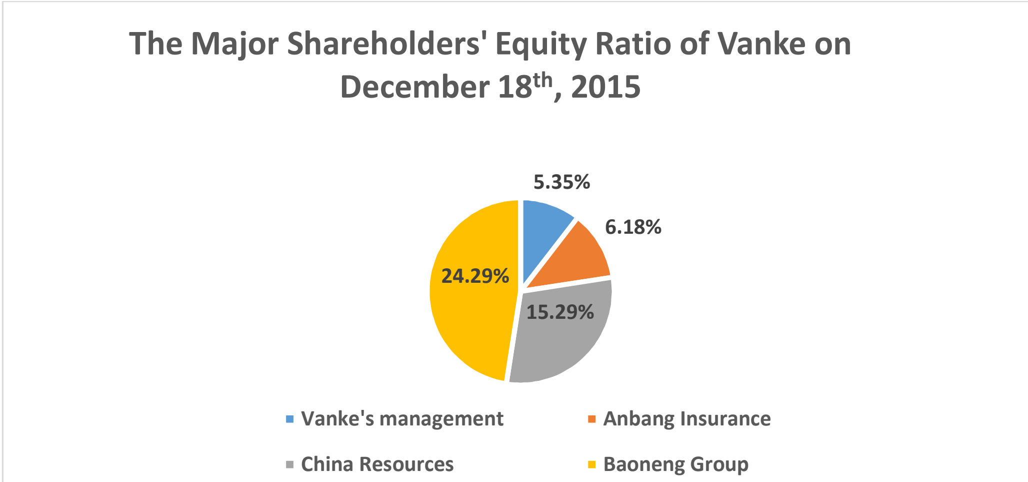

Fig. 1. The major shareholders’ equity ratio of Vanke on December 18th, 2015
Source: eastmoney.com, Shenzhen Stock Exchange

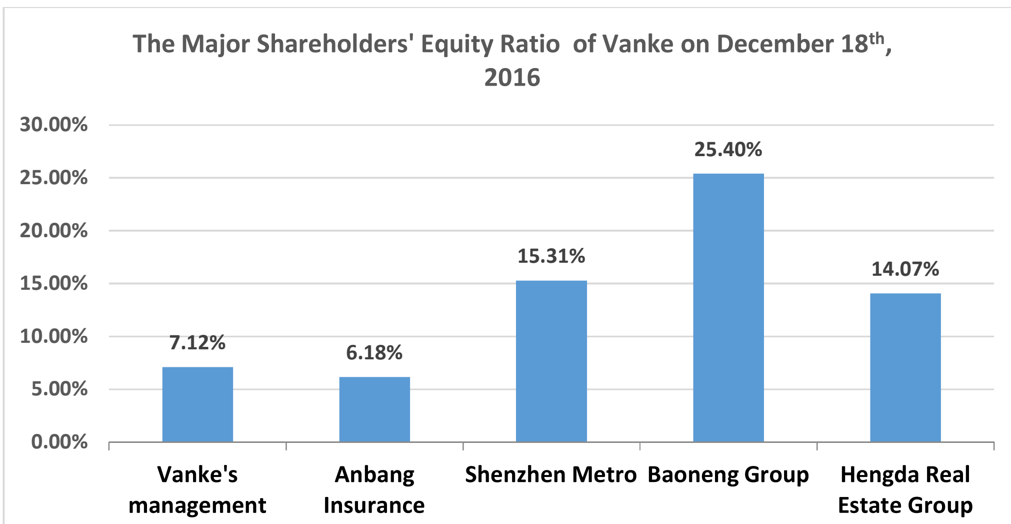

Fig. 2. The major shareholders' equity ratio of Vanke on December 18th, 2016
Source: eastmoney.com, Shenzhen Stock Exchange

4.2.3 Analysis of the reasons for Vanke’s anti-takeover

4.2.3.1 Baoneng group’s low credit rating and lack of operational capacity

Vanke's credit rating is AAA and its financing cost of real estate development is about 4%. But Baoneng Group’s credit rating is comparatively low and its financing cost of real estate development is close to 10%. If Baoneng Group controlled Vanke, the latter would face a credit downgrade crisis and its financing costs would rise. In 2015, the Baoneng Group’s real estate sales were only billions, while Vanke's reached 261.4 billion, ranking first in China. That is to say, Baoneng Group still has a long way to operate an enterprise like Vanke [20].

4.2.3.2 Baoneng group’s short-term borrowing for long-term project, leveraged buyout and its high-risk financing

As shown in the Fig. 3, the money for the acquisition of Vanke was mainly from shareholding pledge, asset management plan, issuance of bonds, bank credit and other means. Financing is characterized by short-term borrowing for long-term project, leveraged buyout, high financing cost and great risk. Baoneng Group is a family business, which will destroy Vanke's own business philosophy and management model when pursuing its own interests.

4.2.3.3 Great negative impact of baoneng group's "barbaric acquisition"

Baoneng Group wantonly bought Vanke's shares in the secondary market without the agreement of the Board of Vanke, which is a typical kind of hostile takeover. Baoneng Group's brutally takeover of Vanke would affect the latter's corporate governance structure and management mode, resulting in a conflict between strategic management and corporate culture, damage of the original business system and worse business performance than before.

4.2.3.4 Entrepreneurs' emotional attribution

Established in May 1984, Vanke Co., Ltd developed into the largest real estate in China with the effort of the management team, which takes Wang as center. In July 2015, Baoneng Group tried to brutally acquire Vanke through leveraged financing. As the company's founder with great emotional attribution to Vanke, Wang took takeover defense measures to protect Vanke's stable development, which is reasonable.

5. THE CONSTRUCTION OF VANKE'S ANTI-TAKEOVER STRATEGY SYSTEM

Takeover defense, also known as anti-takeover, refers to measures taken by the management to protect the company's control power. Based on related literature, this paper draws lessons from the successful experience of anti-takeover of foreign enterprises and takes the battle for equity between Baoneng Group and Vanke as an example to construct the strategy system of Vanke 's anti-takeover, as shown in the Fig. 4.

5.1 Advance Defensive Strategies

5.1.1 To improve the company's articles of association and set anti-takeover terms

Vanke did not modify the articles of association on time, which made it difficult to take effective counterattack measures in the competition of control power. Therefore, it is very important to improve the articles of association and set anti-takeover terms. Especially the terms of restricting the voting rights of major shareholders.

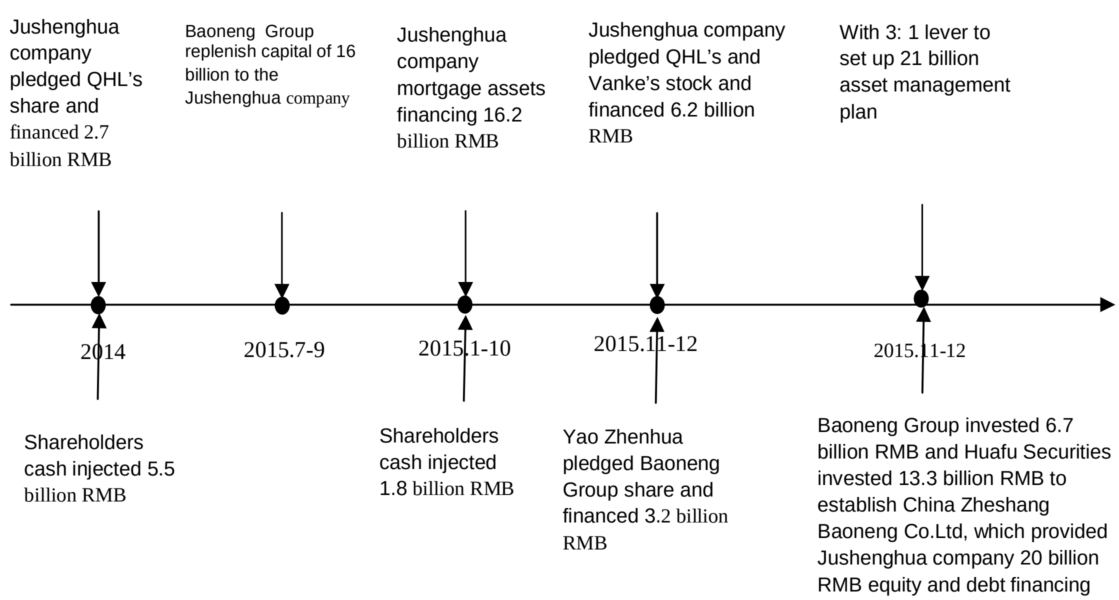

Fig. 3. Baoneng group's financing process
Source: China Insurance Regulatory Commission, eastmoney.com, Shenzhen Stock Exchange

No matter how many shares the largest shareholder holds, he/she/it can only exercise the voting rights corresponding to the restricted stock right [21]. For example, Vanke had set the voting right upper limit to 15% shareholding, though Baoneng Group held 24. 29% of the shares, it can only exercise its voting rights in the corresponding of 15% share. Its control power and the China Resources' would be well-matched in the strength, thus it could hardly control Vanke.

5.1.2 To optimize the company's ownership structure

The battle for equity between Baoneng Group and Vanke resulted from Vanke's ownership dispersal structure, which made it easy for Baoneng Group to acquire. Therefore, the most important anti-takeover measures are to optimize the ownership structure and improve the corporate governance structure. Moderate ownership concentration which refers to an ownership structure with a comparatively powerful controlling shareholder, can not only improve the efficiency of corporate governance and business performance [22], but can also effectively prevent from hostile takeovers. In view of the current ownership dispersal structure, Vanke can optimize its ownership structure, resist hostile takeovers and maintain sustainable development through holding each other's share between listed companies and introducing strategic investors.

5.1.3 Poison pill strategies

Poison pill strategies were put forward by M&A lawyer Martin Lipton. Its core is: when a company encounters a hostile takeover and the acquirer's shares is up to 10% to 20%, it needs a large number of new shares at low-priced. In this way, the company could reduce the acquirer's shareholding to destroy the hostile takeover [23]. The US anti-takeover laws tend to protect the management of companies, allow them to use poison pill strategies to resist the hostile takeover. Sina Co. Ltd. once used poison pill strategies to force the Shanda Co. Ltd. to give up its acquisition of Sina.

5.2 Afterwards Counterattack Strategies

5.2.1 Legal strategies

Legal strategies refer to the methods of stalling to prevent acquisitions through legal proceedings [24]. When Baoneng Group implemented the large-scale acquisition of Vanke, it borrowed huge amounts of money through high degree of financial leverage. Thus, there was a legitimacy problem of the money. Besides, Baoneng Group's credit rating is not high. What's more, after had become the largest shareholder of Vanke, Baoneng Group did not immediately reveal the information to the community, which caused the Shenzhen Stock Exchange to question the Baoneng Group. All these factors can become Vanke's lawsuit reasons.

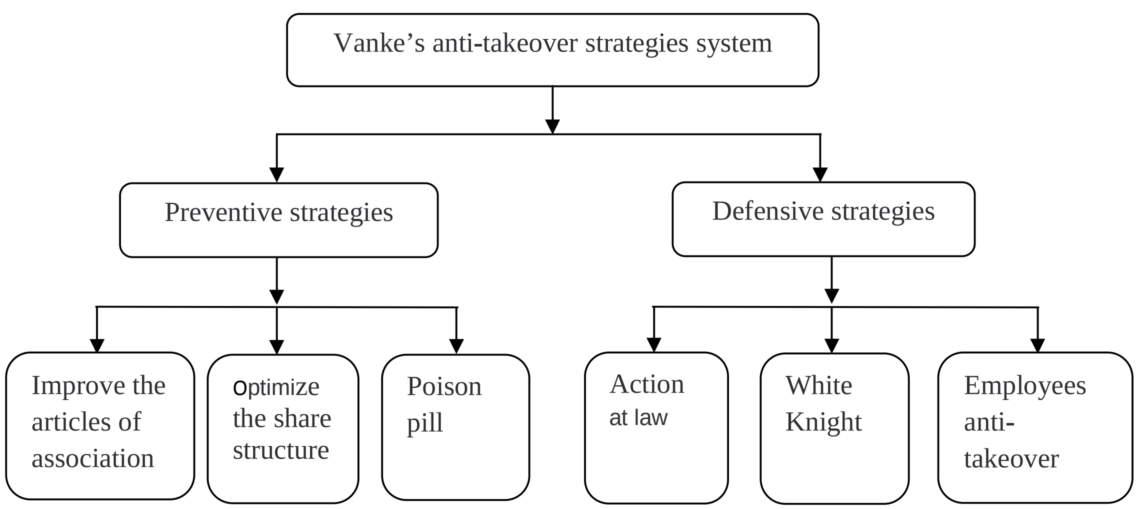

Fig. 4. Vanke's anti-takeover strategies system
Source: Company Act, Security Act, Williams Act

5.2.2 To find a white knight

When a listed company suffered a hostile takeover, the management of the company can go to find a friendly company and cooperate with it to fight back the hostile takeover. Its operating mechanism is to let the "white knight" and the "barbarian" bid for the target company at the same time, which will increase the cost of the acquisition and brings difficulty to the acquirer. Of the 78 successful anti-takeover cases between 1978 and 1984 in the United States, 36 were solved by white knights [25]. Vanke took active actions on inviting Shenzhen Metro to be the white knight, which was a good method to stop Baoneng Group's hostile takeover.

5.2.3 To encourage internal workers and stakeholders to participate in anti-takeover

In the case of the battle for equity between Jinan Securities and Vanke in 1994, Vanke was supported by a lot of small and medium shareholders, and it succeeded in defeating Jinan Securities' acquisition. As for the battle for equity between Baoneng Group and Vanke in 2016, if Vanke want to win the battle, it should encourage stakeholders and employees to participate in its anti-takeover actions [26]. Hostile acquisitions will affect the interests of employees and some stakeholders. Therefore, Vanke can make extensive use of social communication such as media to expand the influence of the hostile takeovers, enhance the emotional attribution of employees and win supports from stakeholders.

To sum up, listed companies should improve the company's articles of association, set anti-takeover terms before the hostile takeover, which is an important premise of preventive strategy. Optimizing ownership structure and improving corporate governance are effective preventive measures. When encountering hostile takeover, Vanke used legal proceedings, actively looked for a white knight and encouraged its employees and stakeholders to participate in this anti-takeover action. In the current anti-takeover legal system, these were very effective and feasible counterattack strategies.

6. CONCLUSIONS AND RECOMMENDATIONS

This research tried to build up the anti-takeover system based on a case study of battle for equity between Baoneng group and Vanke. Although the hostile takeover of Vanke has not come to an end yet, it had far-reaching significance and had a huge impact on the development of China's capital market. And it also gave us important inspiration as follows:

1. Hostile takeover is essentially the forcibly seize of value resources, which has two sides. On one hand, the hostile takeover will result in the loss of resources, a large change of management, which will cause corporate turmoil and corporate culture conflicts. On the other hand, as an important external governance mechanism, hostile takeover can stimulate the management of enterprises to implement more effective strategy to improve the efficiency of corporate governance.
2. Vanke suffered a hostile takeover for its ownership dispersal structure. In view of this, the management of listed companies should maintain the company's development. Meanwhile, continuous improvement of the company's equity structure is needed. And companies should adjust and optimize their corporate governance structure constantly based on their own conditions and the dynamic development trend.
3. After the hostile takeover, the management of Vanke should improve the ownership structure, optimize the corporate governance model, overcome insider control problem and implement more suitable and more reasonable strategies to enhance the company's operating efficiency and add overall value.
4. M&A between companies is encouraged under the sound capital market rules and legal system, because capital market can play an important role in discovering value and can promote the management of listed companies through acquisitions.
5. The company should improve the organizational structure and the ownership structure. Also, the China Securities Regulatory Commission and the China Insurance Regulatory Commission ought to collaborate and communicate with each other more, to perfect supervision mechanism and improve the ability to manage the risk. As for the Legislative branch, it must tighten up the legal system concerning takeover and anti-takeover. At last, the government could put forward a plan aiming at protecting the entrepreneur

and cultivating the culture of respecting the stockholder; in addition, build up a protecting system is important. In a word, all the methods above will do good to the economy development.

The aim of this research is to help regulate the takeover and anti-takeover actions. However, some of the anti-takeover strategies are American style. Whether they are perfect for the Chinese companies should be discreetly considered in practice as well as in the future research.

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COMPETING INTERESTS

Authors have declared that no competing interests exist.

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