Research on Gambling Agreement in Private Equity Financing

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Abstract. Due to the high threshold requirements of applying for a large number of loans from banks, more and more small and medium-sized enterprises have chosen private placement to raise funds, and the betting agreements have been signed to protect the interests of both enterprises and investors. This paper analyzes the case that the bet agreement was applied by Mengniu Dairy and Morgan Stanley in private equity financing. It firstly expounds its background and financing process at that time, then explores why Mengniu Dairy can bet successfully. Finally, countermeasures and suggestions are put forward to promote success of the gambling agreement in private equity especially for small and medium-sized enterprises.

1 Introduction

The term “private equity” originated in the United States in 1946, when the establishment of the first corporate venture capital funds, such as the ARDC (American Research and Development Corporation), represented the emergence of private equity. In 1973, when the former state science and technology commission proposed the "venture capital support" program, private equity began to be introduced to China. One of the most representative cases is the case applied by Mengniu Dairy and Morgan Stanley. They completed two bet agreements and gained win-win situation at the beginning of the 21st century, which started the prologue to the foreign capital into China. After that, since 2007, local private equity (PE) has emerged, China Growth Enterprise Market (GEM) was opened in 2009. In 2017, small and medium-sized enterprises (SME) in mainland China have achieved more opportunities to get funded through private equity. More and more SMEs began to try this way for financing, thus, private equity in China have entered the stage of rapid development.

Bancel and Mittoo pointed out that there is a gap between the enterprise value obtained based on valuation theory and the actual value of the enterprise, so the inconsistency between the valuation of equity investment institutions and enterprises will lead to conflicts [1]. Yitshaki believed that this conflict is caused by the different views of the investment and financing parties on risks and contractual arrangements, and is an inherent attribute of the relationship between the two parties, and the two sides should establish a mechanism to alleviate the conflict [2], and then the gambling agreement was born. Gambling agreement, is also known as “Valuation Adjustment Mechanism (VAM)”, refers to an agreement signed between the investors and enterprise management group, or original shareholders. Both parties agreed to adjust under different performance and market conditions in the future, so as to improve the number and proportion of shares held by investors and the enterprise management group. In short, if the performance of the company has reached the standards stipulated in the contract, then the investor will transfer part of the equity or pay correspondingly to the operator, the management team or its original shareholders. If the performance of the company management group does not meet the standards set out in the contract, the management group or the most controlling shareholders may sell some or even all of their shares to investors. The betting agreement is a powerful incentive mechanism for the management team and an effective clause to prevent investors from encountering pitfalls when buying a business.

Although the theoretical design of the gambling agreement is ideal, there are very few successful cases of Chinese enterprises using gambling agreement to raise money. A number of failed cases arose, such as the case of Harbor Network and Warburg Pincus in 2004, the case of China Yongle and Morgan Stanley in 2005, the case of Xugong Group and Carlyle Investment Fund in 2005, the case of Country Garden and Merrill Lynch in 2008 and the case of Zhangqu Technology and Huayi Brothers in 2010. Many Chinese enterprises in these cases were used to be start enterprises at that time, but they still have failed for various reasons. Among the few successful cases, Mengniu Dairy and Morgan Stanley not only won the bet, but also successfully achieved Initial Public Offering (IPO) in the Hong Kong Stock Exchange, and they also obtained more than 600% of the investment income. This paper will analyze this classic case in detail, summarize the reasons for the success of gambling agreement, and put forward countermeasures and

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suggestions for SMEs in the application of gambling agreement in private financing.

2 Literature Review

Private equity, generally speaking, refers to the collective investment method of raising funds mainly through private placement and investing in the company's owner's equity or quasi equity [3]. Private equity financing refers to the process of private placement to private equity funds through non-public offering. As the financing party in need of funds, the non-listed company first needs to contact with the investment institutions to accept due diligence. After signing the formal agreement, the enterprise will formulate an exit plan for investment institutions and complete private equity financing after reaching the agreed performance IPO. Private equity invests widely in the equity, debt and "mezzanine" interests in between. The enterprise completes the process of private equity financing and handles the corresponding private equity funds [4].

There is a controversy in China over how to set up a private equity investment fund. There have always been different views on whether the limited company system or the limited company partnership system should be applied. Guo Wei and Li Baolin (2018) pointed out that because different organizational forms have their own characteristics and advantages in different fields, the organizational forms of private equity funds have strong industry characteristics [5]. General market funds mostly use the organization form of limited partnership, which can better guarantee income and safety. Special funds, such as positioning to promote the development of emerging industries, promoting the industrialization of scientific and technological achievements, and accelerating the adjustment of industrial structure, all adopt the organizational form of limited company.

Chinese scholars' studies on gambling agreement are divided into three types: theoretical research, legitimacy research, and specific case studies. Firstly, theoretical research studies the content, characteristics and essence of the betting agreement from the basic theoretical perspective. For example, Cheng Jishuang and Cheng Feng (2007) deeply expounds the basic concept, meaning, elements and application essence of China's VAM trading agreement, and puts forward suggestions on how private enterprises can use VAM to achieve a win-win situation for both sides of M&A enterprises by exploring its practicality and application [6]. Yao Zeli (2011) has systematically improved the relevant basic theory of gambling agreement. Secondly, the legitimacy perspective focuses on discussing whether Chinese enterprises are protected by law, whether there is a legal effect and other related issues on gambling agreement [7]. Luo Wenfeng and Li Mingzhi (2014), points out that differences in financing subject' type and property will directly affect the legal effect of the gambling agreement, so we should pay attention to categorize the investors pool into three types of agreement, namely loan type, equity return type and debtor equity transfer conversion type [8]. Furthermore, case studies on betting agreements have increased in recent years. For example, Li Qiyu (2017) discussed the application of gambling agreement in China through the case of gambling agreement of Mengniu. It is pointed out that after major companies see Mengniu's successful gambling agreement, many follow the case. It should be noted that the current operating environment of enterprises is becoming more and more complex, and the risk of using betting agreement financing is also increasing [9]. Wang Zetong (2020) found that the gambling agreement introduced not only avoids the risks to a certain extent, but also makes the win-win results to both parties based on the specific merger and acquisition cases in recent years [10].

In recent years, most of the research on gambling agreement in private financing is also conducted from the perspective of relevant laws and policies, and its theoretical and practical guiding significance needs to be enhanced. Mengniu Dairy (HK.02319) is the first reported betting case in China's private equity financing industry. The management team led by Niu Gensheng achieved the performance agreed with the private equity investors before the listing, and also made huge profits for the three fund investors. Thus, this paper discusses this classic case and aims to illustrate its significance and reasons for success, consequently reveals the risks and provide countermeasures and suggestions to promote gambling agreement in private equity especially for small and medium-sized enterprises.

3 Gambling agreement case analysis on Mengniu Dairy

3.1 Case background

3.1.1 Profile of financing party

China Mengniu Dairy Co., Ltd. was founded in 1999 and is headquartered in Lesheng Economic Park, Helingeer County, Inner Mongolia. It was officially listed on the Hong Kong Stock Exchange in 2004 and became the first Chinese dairy stock to be listed in the Hang Seng Index in 2014, become China's first dairy blue chip dairy company. In August 2020, Mengniu was included in the Hang Kong's Hang Seng Sustainable Enterprise Index and the Hang Seng ESG50index number. Cofco, Danone and ArlaFoods are first and second, and the third strategic shareholder respectively. In ***the World Dairy Enterprise Ranking*** released by Rabobank this year, Mengniu ranked eighth in 2015 and is currently a leading supplier of imported dairy raw materials in China. Mengniu company is committed to mention for rich and diverse natural foods and other products, including a variety of natural liquid milk, ice cream, milk powder and homemade cheese, etc.

3.1.2 Brief Introduction of the key investors

Morgan Stanley is a registered headquarters in the United States US-funded professional large international investment financial services consulting institutions in

New York. It provides a variety of customers with financial services such as business industrial securities, asset risk management, enterprise investment and acquisition or corporate restructuring and bank credit card and other professional funds. Morgan Stanley currently covers more than 1,300 major central cities covering 42 continents and more than 20 countries. Each site has a branch and the total number of employees has reached more than 60,000. Its customers include company, government, institutions and individuals. Morgan Stanley changed the company's registered status to "Bank Holdings" in September 2008. In August 1995, Morgan Stanley and China Construction Bank formed a joint venture with China International Finance Corporation Limited, with 34.3% of its shares in 2010 right to sell all, out of CICC. Morgan Stanley thus became the first IFC to establish a joint venture investment bank in Chinese mainland. Through a joint venture bank in China, China started to establish a Sino-foreign joint venture commercial investment bank in 1949. By a Sino-foreign joint venture commercial bank located in China, Morgan Stanley has been able to successfully raise for many large Chinese companies, financial services for overseas investment. Three of them now include China Unicom, Sinopec, and China Telecom. It has successfully raised more than $10 billion in overseas funds in 20 years. At the beginning of the 21st century, Morgan Stanley's bet with Mengniu Dairy had not only made more than 600% of the profit but also gained prestige among mainland Chinese companies.

3.2 Overview of Mengniu Dairy financing process

3.2.1 Overview of financing background

The newly established Mengniu Dairy obviously cannot rely only on Niu Gensheng and other enterprise management years of industry experience and their warm blood fighting in the dairy industry. If them want to stand firmly in the dairy industry and then seek development, It must be external large amounts of money to achieve, and it is not enough to make a profit every year alone. Mengniu Dairy was a private company Industry, the amount of loans from the bank is far from meeting Mengniu's ambitions. Managements consider the external environment and themselves, then decided to seek private equity financing. In this way, Mengniu Dairy and Morgan Stanley and other three private equity institutions betting agreement financing opened.

3.2.2 The first round of financing

In September 2002, Mengniu Dairy's promoters, investors, employees and associates incorporated Taurus Company and Silver Bull Company in the British Virgin Islands (BVI). Taurus Company and Silver Bull Company each acquired 500 Class A shares (A shares) of China Dairy Holdings, registered in the Cayman Islands, for $1. The Cayman Islands company wholly owns 100% of the Mauritius company. If you look up the registration time, you will find that Taurus and Silver Bull are registered later than Cayman Islands company. Both Cayman Islands company and Mauritius company are pre-registered by lawyers and do not have any business activity (Shelf Corporation) that specialize in selling to start-ups to save their time in registering their businesses (see Figure 1).

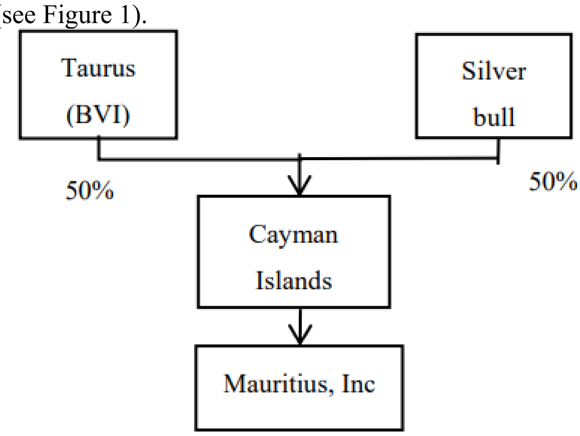

Figure 1 Equity structure of Mengniu before the A round of financing.

In October 2002, three funds, including Morgan Stanley, injected about $25.97 million (equivalent to about 210 million yuan) into the Cayman Islands through a share subscription method, obtained 48,980 new B shares. Taurus and Silver Bull are recognized at $1 per share bought 4,012 A-shares issued by The Cayman Islands Corporation for an investment of $4,012. In addition to the 500 shares previously held by Taurus and Silver Bull, the BVI company controlled by the two management teams holds 5102 A shares. A shares have 10 votes per share, and B shares have only one vote per share. In terms of the number of shares, investors in A shares and B shares hold 9.4% and 90.6% of the beneficiary rights respectively. From the perspective of voting rights, investors in A shares and B shares hold 51% and 49% of the voting rights respectively. The funds invested by the three funds were injected into the Mauritian company through the Cayman Islands company, which used the proceeds to acquire a 66.7% stake in Mengniu Dairy in the mainland. Mengniu Dairy was changed to a Sino-foreign joint venture. The three funds agreed with the management team that if Mengniu's net profit in 2002 increased by 100% compared with the previous year, A shares could be converted into B shares at a ratio of 1:10. Mengniu's actual net profit in 2002 increased by 129% compared with 2001. In September 2003, 5,102 A shares held by Taurus and Silver Bull were converted into 51,020 B shares (see Figure 2).

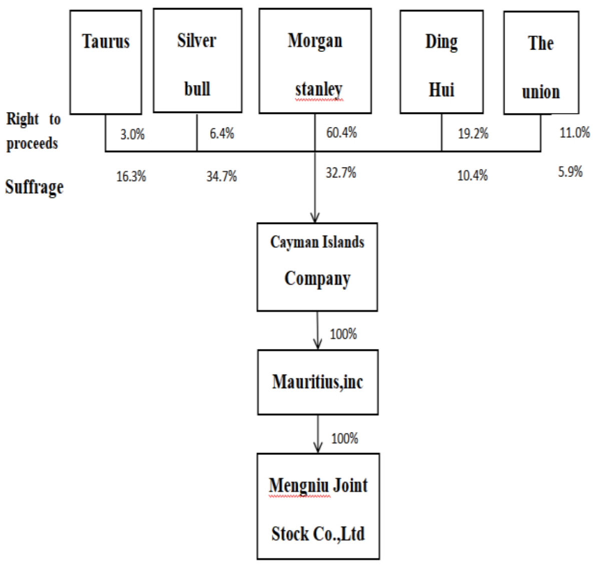

Figure 2 Equity structure of Mengniu after the A round of financing.

3.2.3 The second round of financing

Prior to the second round of financing, all B shares were converted into common stock with a par value of $0.001. In addition, Taurus and Silver Bull received dividends (performance excess awards) paid in the form of common shares, totaling 43,636 shares. After the bonus shares, the proportion of shares held by Taurus and Silver Bull reached 65.95%. In October 2003, the three funds identified convertible bonds issued in the United States by Cayman Islands companies in their second round of financing. The amount of convertible bond financing increased its shareholding in Mengniu through the Mauritian company, with a shareholding ratio of 81.1%, and the main terms of the convertible bonds are as follows:

(1) Financing amount: $35.23 million;

(2) Exercise Price: It can be converted into 368 million common shares at the price of US $0.096 per share;

(3) Exercise time: 30% of Mengniu's feasible rights after 6 months of listing; 100% viable rights after 12 months of listing; If Cayman Islands company or its affiliates are merged or acquired, it can be exercised at any time;

(4) Interest payment: dividends equivalent to the corresponding proportion of common shares;

(5) Redemption clause: The listed company must redeem the convertible bonds after 5 years of listing; In the event of If Cayman Islands company or its affiliates are merged or acquired, bondholders may require the issuer to redeem more than 51% of its bond holdings at a price of 1.2 times the net asset value of 12% per annum.

In March 2004, as an appreciation for Niu Gensheng's personal contribution, each of the three funds sold 6.1% of their Cayman Islands company holdings to Niu Gensheng for $1 (equivalent to a gift). Then Niu Gensheng promises:

(1) When the three funds hold at least 25% of Mengniu's shares or within five years of Mengniu's listing (whichever is shorter), he will not join any Mengniu competitors;

(2) The three funds have the right to subscribe for certain shares of Mengniu Co., Ltd. held by Niu Gensheng within ten years.

In February 2004, Mengniu Dairy Company (listed entity), registered in the Cayman Islands, was established in order to prepare for listing. In May 2004, all shareholders and creditors of the Cayman Islands Company transferred their interests to Mengniu Dairy Company, which became a 100% shareholder of the Cayman Islands Company. As consideration, Taurus, Silver Bull, Niu Gensheng and the three funds received corresponding proportions of common shares and convertible bonds respectively. This step of stock exchange is very common in overseas listings, and it does not substantially change the company's capital structure, but only changes the listed entity. Before the listing, Mengniu Dairy's red-chip structure is shown in Figure 3.

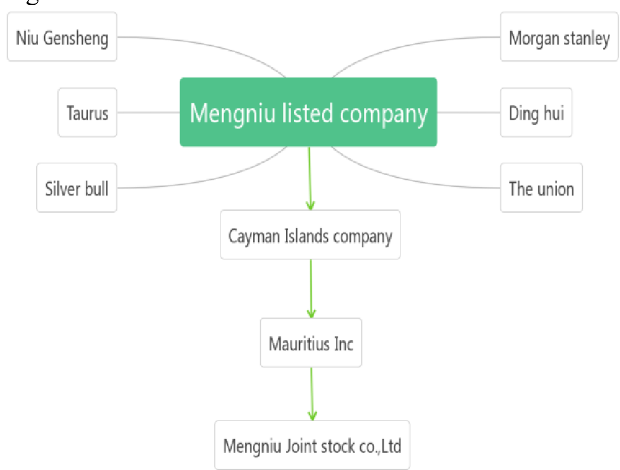

Figure 3 Red-chip structure of Mengniu before listing.

On the same day of signing the stock exchange agreement, the three funds signed a shareholder agreement with Taurus Company to set up a valuation adjustment mechanism. The two parties agreed that if Mengniu Dairy's profit compound annual growth rate exceeds 50% in fiscal year 2004-2006, the three funds will transfer the shares of the listed company to Taurus Company free of charge according to a certain formula; If this performance target is not fulfilled, Taurus will transfer the corresponding number of shares of the listed company to the three funds free of charge according to the formula. In addition, if the Taurus loses, you can choose to pay in cash instead of stock. The maximum number of shares that the two parties can bet on is 78.3 million shares, which is equivalent to 7.8% of the shares of the listed company before the convertible bonds were exercised.

3.2.4 Gambling against the win-win, institutional profits, Mengniu became the dairy industry leader

In April 2005, the three funds reached an agreement with Taurus to terminate the valuation adjustment mechanism early. The three funds transferred $5.99 million in convertible bonds (equivalent to 62.6 million common shares) to Taurus free of charge. Mengniu Dairy has shown a rapid growth trend since the beginning of the bet in 2002, according to rough estimates, the three funds injected about HK$470 million into Mengniu Dairy, cashed out HK$2.99 billion during the investment period, and made a profit of about HK$2.52 billion (see Table 1).

Table 1. Total institutional income

Time	Income per time (10,000 yuan)	Total income (10,000 yuan)	Investment amount (10,000 yuan)	Investment return rate (%)
2004.6	35250.00	/	/	/
2004.12	168607.38	299887.38	47738.48	628.19
2005.6	96030.00	/	/	/

Data source: Mengniu Dairy annual report.

Mengniu Dairy, on the other hand, has not only steadily increased its share price because of its success in gambling (see Figure 4). At the same time, in the increasingly fierce competition, the major dairy companies are competing for the dairy industry, not only resisting the pressure exerted by Yili, but also expanding the market, repeatedly and rapidly increasing market share, and finally becoming the leader in the dairy industry.

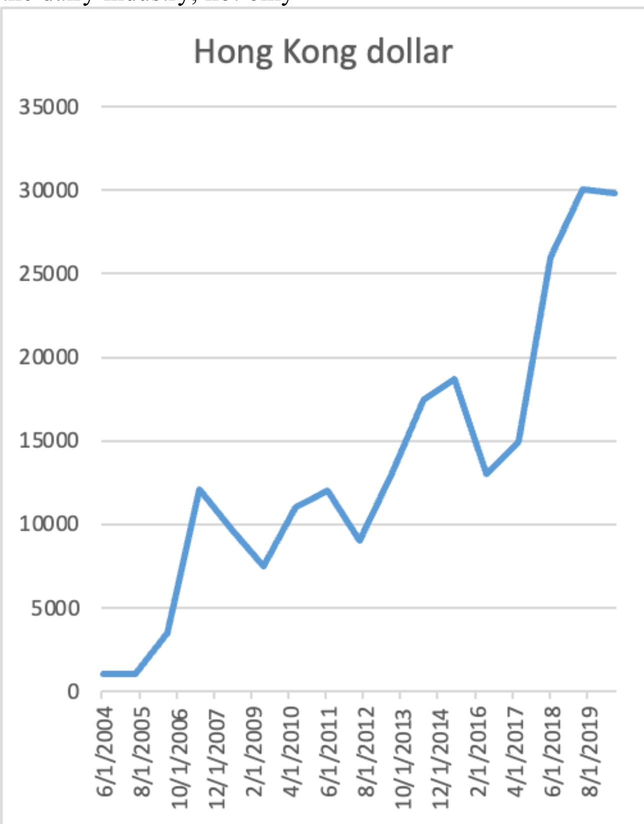

Figure 4 Monthly closing price of Mengniu Dairy Industry.

3.3 Analysis of the successful reasons of Mengniu Dairy

3.3.1 The careful betting process ensures their own rights and interests

In order to seek development and listing, Mengniu Dairy did not complete the gambling agreement with Morgan Stanley and other three institutions at one time, but was divided into two different stages of gambling, and the two capital investment methods were also taken in different ways, which is a very cautious and beneficial process for both parties.

Morgan Stanley and other three institutions in the first round of financing with equity subscription injection of funds, signed the first round of betting agreement. Mengniu Dairy completed 29% more than the agreed net profit growth, significantly increased its profitability, and successfully converted A shares into 51,020 high-yield B shares. In the second round of financing, Mengniu Dairy did not adopt the capital injection method of taking control as a condition for gambling in the first round of financing, but negotiated with Morgan Stanley and other three institutions with the excellent completion of the first round of financing, finally, adopt the way of convertible bonds to complete the capital injection. The second round of convertible bond capital injection not only enabled Mengniu Dairy to achieve considerable development and steadily improve its performance year by year, but also did not dilute the share rights in the pre-listing financial reserve, but also ensured that the equity structure did not change and ensured its own rights and interests (see Table 2).

Table 2 Overview of the bet agreement.

Signing time	Terminal time	Betting content	Bet outcome
2002	2003	Compound growth rate of 100%	success
2003	2005	Compound growth rate of 50%	Success and Investors terminate early

3.3.2 Dexterously protected control with shell companies

Mengniu founded two shell companies, Taurus and Silver bull, long before signing the first round of betting agreements, and the capital operation was carried out indirectly through these two shell companies in the process of both rounds of gambling. Because a large amount of capital is injected into the enterprise when the enterprise is financing, the control is particularly valued by the management of the enterprise, and the content of the gambling agreement has become a particularly critical place to protect the control. Mengniu Dairy stipulates that the shares of the two shell companies have a certain prohibition period, which undoubtedly gives Mengniu Dairy considerable room for manoeuvre.

Mengniu Dairy with its excellent performance and clever use of shell companies for capital operations not only obtained the right to profit, and in the process of financing to protect their actual control of the enterprise.

3.3.3 Accurate strategy formulation ensures the development of the enterprise

Mengniu Dairy, established in 1999, coincided with the rapid development of China's reform and opening up, and the consumption and demand of Chinese people are rising rapidly, and the consumption level of dairy products is also rising rapidly. Although China's dairy industry was relatively weak at that time, the annual per capita fresh milk consumption in the country was 6kg, far lower than the world average of 100kg, and the total milk production accounted for only 1% of the world's total milk production, but this just shows that China's dairy industry has great potential and is full of opportunities.

The management of Mengniu Dairy accurately seized this opportunity through the macro analysis of the national environment and the industry, after signing the first round of gambling for financing for the rapid expansion of the company, they did not rush to formulate a short-term high-yield strategy in order to achieve the successful result of the gambling, regardless of the long-term interests of the company. Entrepreneurs' tendency to short-term goals will have a negative impact on the long-term prospects of the project [11].Mengniu Dairy avoided the wrong strategy caused by short-sighted behavior that led to the second round of capital injection into Mengniu Dairy by three institutions including Morgan Stanley. Accurate strategy formulation and huge development potential are also the bargaining chips of Mengniu Dairy in the negotiation of the gambling agreement.

4. Suggestions to promote gambling agreement for SMEs

4.1 Carefully consider the various factors affecting gambling

For SMEs that need capital to develop, the risk coefficient of private equity financing is higher than that of debt financing and internal financing. If the bet is lost and the gambling target is not reached, the financier not only needs to compensate the investor for a large amount of equity as compensation, but may even lose control of the business. Therefore, SMEs should not take private equity financing as the first consideration when solving the capital problem, and should first try financing methods with lower cost and lower risk coefficient in the initial stage, and then consider more diversified financing methods after certain development.

Industry conditions are also an important factor for financiers to consider. The case of Mengniu Dairy in this article is a period of rapid development of the dairy industry at the beginning of the century, and enterprises in the industry have great development potential, which is one of the reasons why Morgan Stanley and other tertiary institutions are willing to gamble with Mengniu Dairy. Therefore, the value adjustment mechanism can deliver the quality signal of target party, and also to some extent reflect the expected performance to its future profitability [12]. If the industry has passed a period of rapid development, or even the industry giants have formed a trend of gradual monopoly, it will be difficult for enterprises to bet on this industry situation to achieve the agreed performance.

In addition, enterprises need to accurately assess their own situation, and it is necessary to accurately assess the risk tolerance of their own enterprises. Mengniu Dairy itself has an experienced management team, and its own valuation is very good at risk control. Small and medium-sized enterprises need to be cautious and serious about their own valuation, excessive valuation often lays hidden dangers in future gambling, and over-bottom valuation will not attract investors. Accurate self-assessment to avoid unbearable risks in gambling.

Choosing the right financing partner is also one of the factors that financiers need to consider carefully. For SMEs, choosing the right financing partner is not only to raise funds for development, but also to choose a strategic partner for long-term development in the future. In particular, small and medium-sized enterprises in the start-up stage can learn from financing partners that mature management methods, operation methods and other valuable experience that will help them develop further.

4.2 Set the right betting target

When signing a gambling agreement, you need to pay attention to the setting of gambling goals, which includes two aspects. One is a gambling indicator, and the other is the corresponding standard of a gambling indicator. Just like Mengniu Dairy takes performance as an indicator of gambling agreement and the compound annual growth rate of profitability as the corresponding criterion for gambling agreement indicators. The indicators of gambling are relatively single, and most of them use the performance of the enterprise as the indicators of gambling. For the long-term development of the enterprise, consider adding non-financial indicators to the financial indicators as the gambling agreement indicators in the negotiation of the gambling agreement.

The corresponding specific standards of the gambling agreement index should be formulated in the negotiation in combination with the social environment at that time, the development trend of the industry and the profitability of the enterprise itself. Enterprises can design flexible multi-grade targets in the gambling agreement, with goals that can be floated up and down, to avoid possible adverse factors, so that financing and gambling agreement can achieve a win-win situation for both parties.

4.3 Build a high-level management team

After the end of the bet, the capital is cashed out, a high-level management team is indispensable if the enterprise wants to continue to show a high-speed development trend. In the financing process, enterprises should avoid relying too much on the strength of investors. During the financing period, carefully learn the management mode of the other party to avoid the lack of staying power for the development of the enterprise due to the neglect of management team building and the loose internal system after achieving the gambling goal. The management team needs to continuously improve its own level, cooperate with the leaders' decision-making, and avoid being shortsighted based on the future, in order to continue to develop rapidly after the completion of the gambling and become an evergreen tree in the industry.

5.Conclusion

The betting agreement is a powerful incentive mechanism for the management team and an effective clause to prevent investors from encountering pitfalls when buying a business. This paper discusses the application of the gambling agreement in the private equity financing of Chinese enterprises through case study. It finds that the prudent gambling process ensures Mengniu Dairy’s own rights and interests. Via accurate strategy, the enterprise cleverly protects the control right with the help of shell companies, which ensures its development. Based on these findings, this paper puts forward suggestions and references for enterprises to avoid risks, which has practical significance and theoretical value. However, because the gambling agreement has appeared in short time in China, there is still difficulty to obtain enough internal information. Quantitative modeling and analysis of large samples are difficult to conduct. Therefore, future research can be carried out to mine macro data and explore the problems and countermeasures in private equity financing in China from the perspective of big data.

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