

Research on the Impact of Equity Pledge on Company Value

Tao Zhang, Xuxu Zhu, Jie Tian*

Hebei GEO University, Shijiazhuang 050030, China

*Corresponding author: Jie Tian, zt18363076990@163.com

Copyright: © 2024 Author(s). This is an open-access article distributed under the terms of the Creative Commons Attribution License (CC BY 4.0), permitting distribution and reproduction in any medium, provided the original work is cited.

Abstract: This article aims to provide a literature review on the impact of equity pledges on corporate value, and to explore in depth the application of equity pledges as a financial tool in corporate governance and capital operation, as well as its multidimensional impact on corporate value. By reviewing and analyzing relevant literature both domestically and internationally, this article first defines the basic concept of equity pledges and then elaborates on the impact mechanism of equity pledges on company value from both positive and negative perspectives. In terms of positive impact, this article explores how equity pledges can promote corporate financing, optimize capital structure, and enhance the control of major shareholders over the company. In terms of negative impacts, the possible control risk, market risk, and potential damage to the interests of small and medium-sized shareholders brought about by equity pledges were analyzed. Furthermore, this article also discusses the differences in the impact of equity pledges on company value in different scenarios and proposes corresponding policy recommendations and research prospects.

Keywords: Equity pledge; Company value; Financing; Corporate governance; Market risk

Online publication: August 26, 2024

1. Preface

An equity pledge is a form of guarantee, which guarantees the performance of debt. The debtor (company) or a third party pledges their equity to the creditor (bank, securities firm, etc.) in accordance with the law. If the debtor fails to fulfill the debt or the parties agree to realize the pledge, the creditor has the right to priority compensation for the equity.

Simply put, an equity pledge is a way for shareholders to use their equity as collateral to borrow from financial institutions. When the stock price drops to the warning line or liquidation line, and the controlling shareholder is unable to timely replenish or add collateral or redeem the pledged stocks in advance, the pledgee has the right to dispose of the pledged stocks, and the controlling shareholder will lose control.

Since 2015, equity pledges have become popular in China's capital market due to its convenient financing, low cost, and less restricted use of funds compared to debt financing.

This article systematically reviews the existing research results on equity pledge from both positive

and negative effects, and based on the results, looks forward to future research directions and proposes corresponding policy recommendations.

2. Literature review

This section mainly focuses on the literature review of the impact of equity pledge behavior on company value. By sorting out domestic and foreign literature on equity pledges, it is found that compared to foreign countries, the development of China's domestic equity market is relatively slow, and related research has only been given more attention and development in recent years. Currently, most scholars focus on discussing the specific behavior of listed companies and their impact on stock prices and equity by using partial annual data from A-share listed companies in Shanghai and Shenzhen from 2000 to 2020 or using a specific company as an example. There are many controversies about the impact of equity pledges on company value and the conclusions drawn are mainly reflected in both positive and negative effects. Therefore, this article mainly starts from the motivation of equity pledges and focuses on examining the positive and negative effects of equity pledges on company value.

2.1. Motivation for equity pledge

Existing research indicates that in the process of company operation, there are two main motivations for shareholders to engage in equity pledge behavior under different circumstances, goodwill motivation and malicious motivation, and different types of pledge opportunities result in different economic consequences. Driven by goodwill motivation, shareholders only view equity pledges as a financing tool and actively promote the increase of company value. So, when a company faces financial difficulties, pledging equity to meet the cash flow requirements for normal operation is currently the main reason for most company shareholders to pledge equity in the market ^[1]. Additionally, it is not ruled out that due to the company's difficulties and the motivation to cash out through a pledge, the company may withdraw its equity pledge to maximize its own interests ^[2].

2.2. The positive effects of equity pledge

One major advantage of equity pledges is that it is more convenient and cost-effective compared to ordinary financing methods. From the perspective of financing needs, the main reason why shareholders pledge their equity is that the company lacks the necessary cash flow for operation. As a financing method that does not require physical collateral, equity pledges directly use equity as collateral, which is faster and less restrictive ^[3].

Another advantage of equity pledges is that they not only meet the financing needs of the enterprise but also do not cause shareholders to lose their control ^[4]. However, if the pledged equity is forcibly liquidated, it will have a significant impact on the control and stock price of the listed company. Therefore, major shareholders have stronger incentives to improve the company's operation and performance after the equity pledge ^[5].

From the perspective of corporate governance effects of multiple major shareholders, the pledge of equity by controlling shareholders significantly reduces the encroachment of interests, improves earnings information, and reduces the risk of stock price collapse ^[6].

From the perspective of tax avoidance, moderate tax avoidance can increase a company's expected post-tax earnings, bring wealth effects to shareholders, and promote sustainable development ^[7,8].

2.3. The negative impact of equity pledge

Through the research of scholars in the previous text, we found that when a company pledges its equity, it

becomes a double-edged sword for the company. This is not only reflected in the positive effects of goodwill motivation mentioned earlier in this article but also in the increased credit risk caused by goodwill motivation and the shareholder encroachment on the interests of small and medium-sized shareholders and even the company's interests caused by malicious motivation.

2.3.1. Credit risk brought by equity pledge to listed companies

When the financing environment becomes tight or stock market prices fluctuate violently, shareholders may bring credit risk to the company due to their higher equity pledge ratio. On the one hand, obstructed financing can put pressure on shareholder liquidity, especially for major shareholders. If the financing scale is higher than the value of collateral assets, controlling shareholders may choose to give up their shares and empty the listed company, causing it to fall into trouble. On the other hand, the drastic fluctuations in stock prices require additional margins in the stock market, and may even be forced to close positions. Investors may also liquidate their stocks in advance. In cases of excessive liquidity pressure, risk spreads among shareholders, narrowing financing channels, and ultimately forming a liquidity crisis. In the future, when there is excessive capital turnover pressure, credit risk will be further exacerbated. Li's research found that the intensification of credit risk significantly suppresses the increase in enterprise value ^[9].

2.3.2. Stock pledge behavior driven by malicious motives

Previously, scholars focused on discussing the impact of equity pledges on company value, but few scholars have combined the impact of equity pledge ratio on company value. From the perspective of agency theory, Fan found that the higher the equity pledge ratio, the lower the performance of the listed company ^[10]. He believed that there was a separation of ownership and management rights, as well as information asymmetry between them. There would be conflicts of interest between shareholders and management, major and minor shareholders, and shareholders and creditors. Equity pledges would lead to the separation of control rights and cash flow rights of major shareholders. Although major shareholders still hold control rights, this would weaken the incentive effect of stocks. Therefore, major shareholders are likely to transfer risks to the company for their own interests, ultimately resulting in a decline in company performance. Yu analyzes the equity pledge of controlling shareholders of Duo Ai Company ^[11]. When the company's stock price is high and there are many restricted shares, an equity pledge gives shareholders sufficient motivation to empty the listed company. Therefore, shareholder pledge behavior not only brings risks to the company but also has adverse effects on the interests of other stakeholders. Meanwhile, literature in the field of accounting has found that the higher the review fees paid by a company, the poorer the quality of its financial statements, and the greater the possibility of financial fraud. Wang found that the number of penalties received by regulatory authorities by listed companies is positively correlated with the proportion of equity pledges by controlling shareholders ^[12].

By using Huanrui Century as a sample, Du found that when the stock price drops, a large number of shares pledged by major shareholders will face the risk of supplementary pledges and liquidation of pledged shares ^[13]. Once liquidation occurs, shareholders cannot cope with the risk of liquidation due to the lack of excess shares for supplementary pledges, and their limited financing channels ultimately lead to the transfer of control of the company. He and colleagues also found through empirical research on the Chinese market that there is a strong correlation between the proportion of equity pledges of listed companies and their market value, and a high proportion of equity pledges will face the risk of control transfer ^[14]. Taking Guangyi Technology as an example, Lu found that frequent equity pledging, high pledging ratios, and large amounts of pledging financing can all exacerbate the risk of pledging, ultimately leading to a continuous decline in its stock price. Although

Guangyi Technology's market value management behavior alleviates the risks brought by equity pledging in the short term, it has not fundamentally improved its intrinsic value and business performance, resulting in financing shortages and a decline in company value. Su also verified this view and the behavior of major shareholder equity pledging can have a suppressive effect on the sustainability of listed company profits^[15].

He, Huang, and Zhou pointed out in their article "The impacts of share pledging on firm investment timing and valuation" that equity pledging exacerbates overinvestment by enterprises and worsens their underinvestment. Unless proactive measures are taken to control the risk of the pledge, the equity pledge will damage the option value of the enterprise.

3. Conclusion and recommendations

This article conducted a literature review and summary from three aspects: the motivation of an equity pledge, and the positive and negative effects of an equity pledge. Overall, an equity pledge has both advantages and disadvantages and is a double-edged sword. From the perspective of modern enterprise management, the goal should be to maximize shareholder equity. Therefore, credit management risks are particularly important, and it is necessary to pledge reasonably instead of financing without restraint.

3.1. Optimize enterprise asset structure

In the current downward trend of China's economic situation, the difficulty of enterprise financing has become a common problem. Traditional financing methods make it difficult to meet the funding needs of companies. Although equity pledges can solve the financing difficulties of enterprises in a convenient and fast way, they not only pose certain risks to financial institutions and markets but also put considerable pressure on the long-term development of enterprises. Therefore, it is important to control the use of enterprise cash flow, avoid the occurrence of liquidity shortage, and strengthen the awareness of enterprise equity pledges.

3.2. Establish a credit risk management system

For large enterprises, establishing a good corporate culture and establishing a good reputation image is particularly important in the current era of informatization and digitization. It is necessary to continuously strengthen and improve the company's credit system, as well as establish a complete and specialized credit management and internal control department within the company. Moreover, through the supervision and evaluation of third-party intermediaries, potential credit risks of the enterprise can be effectively prevented, ultimately achieving the goal of stable development of the enterprise.

3.3. From the perspective of shareholder balance, introduce institutional investors

Based on the literature review above, pledging the equity of major shareholders will have a certain negative impact on the overall performance of listed companies. Therefore, it can be considered to introduce institutional investors to play a balancing role against major shareholders. Compared to other shareholders, institutional investors have a more complete and standardized internal governance model of the company, participate in company decision-making, and can effectively guide and supervise major shareholders to suppress their "hollowing out" behavior.

4. Future prospects

At present, the equity pledge behavior of listed companies in China has become increasingly common, and

with its widespread use, its influence is also expanding. More and more scholars are analyzing and studying the different perspectives of equity pledges on company value. After the literature review, this article believes that future research on equity pledges should seek breakthroughs in the following areas.

From an external perspective, conduct in-depth research on the mechanism and path of the impact of equity pledges on company value. At present, research based on the perspective of internal corporate governance is becoming more comprehensive, but analysis combined with external governance environment still needs to be supplemented.

From the perspective of data selection, most scholars in the past have used sample data from listed companies in the Shanghai and Shenzhen A-share markets. However, the nature of controlling shareholders in state-owned and private enterprises in China is different. The market share and operating performance of different enterprises vary greatly. Therefore, a detailed distinction will help explore whether the equity pledge of controlling shareholders is based on agency theory and the “hollowing out” behavior of listed companies. This viewpoint still needs further discussion from more scholars.

Disclosure statement

The authors declare no conflict of interest.

[1] References

- [2] Xu X, Tang T, Lu Z, 2021, Pledge of controlling shareholder equity and leverage manipulation of highly leveraged companies: empirical evidence based on A-share listed companies in China. *Financial Research*, 2021(10): 153–170.
- [3] Zhu W, Chen X, Kan L, 2020, How equity pledge affects the value of listed companies. *Finance and Accounting Monthly*, 2020(02): 48–55.
- [4] Lan Y, 2021, Research on the Impact of Major Shareholder Equity Pledge on Corporate Behavior, thesis, Shanghai University of Finance and Economics.
- [5] Lu Y, Qian F, 2022, How does the pledge of major shareholder equity affect market value management and company value? *Management Case Study and Review*, 15(05): 582–594.
- [6] Zhang Y, Sun Z, Zhou Y, et al., 2022, M&A Goodwill and corporate technological innovation: The mediating modeling effect of stock pledges. *PLoS ONE*, 17(8): e0271214.
- [7] Jiang F, Shen Y, Cai X, et al., 2020, Corporate Governance Effects of Multiple Major Shareholders: From the Perspective of Controlling Shareholder Equity Pledge. *World Economy*, 43(02): 74–98.
- [8] Li X, Lei L, 2023, Equity Pledge and Corporate Value of Listed Companies: A Study on the Mediation Effect Based on Credit Risk. *Productivity Research*, 2023(08): 149–153.
- [9] Fan W, 2022, Pledge of Major Shareholders’ Equity, Internal Control, and Corporate Performance. *Business Accounting*, 2022(13): 68–72.
- [10] Li L, Cao X, Cao J, et al., 2023, Controlling shareholder equity pledge and corporate value: impact effects and path analysis. *Accounting Friends*, 2023(19): 22–28.
- [11] Wang X, Ma C, 2022, Equity Pledge and Company Valuation: Theory and Empirical. *Financial Research*, 2022(12): 187–206.
- [12] Du S, Yu K, 2023, Risk drivers and consequences analysis of high proportion equity pledge by major shareholders: A case study of Huanrui Century. *Accounting for Rural Enterprises in China*, 2023(09): 12–14.
- [13] Li M, Liu C, Scott T, 2019, Share pledges and firm value. *Pacific-Basin Finance Journal*, 55: 192–205.
- [14] Su M, Zhang H, 2022, Pledge of Major Shareholders’ Equity, Nature of Equity and Sustainability of Earnings. *Business Accounting*, 2022(16): 79–83.

- [15] He M, Huang D, Zhou J, 2023, The impacts of share padding on firm investment timing and evaluation. *International Review of Financial Analysis*, 2023, 87: 102571.
- [16] Li X, Zhang X, Zhang Z, 2022, The impact of equity pledge by major shareholders of listed companies in China on company performance. *Liaoning Economic Journal*, 2022(11): 66–73.

Publisher's note

Bio-Byword Scientific Publishing remains neutral with regard to jurisdictional claims in published maps and institutional affiliations.