PERSPECTIVE

Developments in the Reform of China's State-Owned Enterprises

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Chinese stocks have been soaring in the first half of this year, and I've often been asked about whether I expect a correction—or whether there's more room to run. It's important to note that China's stock market is really multiple markets–the Shanghai (A Share) and Hong Kong (H Share) markets are dominated by State-Owned Enterprises (SOEs) considered "blue chip" stocks, while the Shenzhen (A Share) market is home to smaller domestic stocks. Many investors' interest in China's SOEs has no doubt been piqued by guidance from sources close to the government that reform plans foreshadowed in the government's November 2013 program could soon begin to assume a more concrete shape, helping drive the recent gains in the Shanghai and Hong Kong share markets. In fact, many SOEs have already experienced significant share price volatility in recent weeks and given the extent of the market's rally this year, it certainly would not surprise me to see more volatility ahead in China's markets.

The SOEs are a crucial instrument of Chinese government policy and we think reform is crucial to the overall improvement of the economy. Representing perhaps two fifths of China's economic output and a fifth of the country's jobs,[1] they have been a key mechanism for transmitting stimulus to China's wider economy, through mandated investment plans, financed through the medium of preferential loans from state banks. On the other hand, ill-thought out and politically motivated investment has caused returns on SOE assets to fall from around parity with the private sector in 2008 to little more than half the level achieved by private businesses at present,[2] with a number of SOEs appearing to be in financial difficulty due to rising debt loads and weak profitability. More than ever, the government now appears determined to tackle management shortcomings within SOEs in order to reshape China's economy to a more market-oriented and entrepreneurial mold.

The present composition of China's SOE system is the result of an earlier reform push that goes back nearly two decades. In 2014, the nature of the reforms planned by the Chinese government was unclear. Subsequent activity suggests that "privatization" as recognized in the West, with enterprises bought and sold in part or in full to the private sector, and the state withdrawing from involvement in management, does not appear to be on the agenda, at least for central government-controlled businesses.

In six enterprise pilot schemes of SOE reforms announced in April 2014, only two involved private capital, with the companies looking to inject additional assets into existing quoted subsidiaries leaving a mixed ownership overwhelmingly dominated by state shareholders. Two other companies experimented with an independent board focused on capital management, providing a barrier between the business and its state owners, somewhat akin to the model developed in Singapore. Yet another pilot kept the SOE structure more or less in place, but gave the SOE board rather than the state owner the power to appoint and incentivize the management team.[3] The reforms appear to reflect a view in government circles that the key is to place circuit breakers between the CEO management and their government owners, with either the management themselves or an intervening level of asset management companies charged with enforcing a market-oriented business strategy.

Various individual SOEs have undertaken their own initiatives since the pilot scheme was announced. A major nuclear power engineering business and a financial services business have adopted similar schemes, with the assets of the state-owned holding companies injected into the quoted subsidiaries. A major oil company sold a minority stake in its petrol retailing subsidiary to a group of investors, with a view to an eventual initial public offering (IPO). A cement company underwent a capital restructure, leaving an employee-controlled body as the largest shareholder of the business. Yet other companies appear to be following a more traditional route of inviting private capital into specific joint ventures, with, in a number of cases, management granted an equity share in the businesses they run.

In recent months, China's government seems to have been leaning toward another route to reform. The merger of two state railway engineering businesses was carried out in order to avoid duplication of resources to create greater scale in overseas markets. This proved extremely popular with investors, and commentary in well-connected journals has pointed to further initiatives along the same lines. In one report, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) was reported to be planning a drastic cut in the number of centrally controlled SOEs from the present 112 to perhaps only 40, although the report, in the state-controlled *Economic Information Daily*, was subsequently downplayed in a SASAC release.[4] Rumors of merger plans have nevertheless persisted.

In our view, judging by the reception of the railway merger, a wave of SOE corporate activity could potentially create significant opportunities for investors. However, a mere increase in scale without any other reform might have fewer long-term consequences on the SOE sector in terms of increased efficiency or market sensitivity, than was envisioned at the time of the original reform announcements. Of course, mergers, should they take place, would not preclude other measures, but the centrally owned SOEs may not in any case be the right place to look for early, ambitious reforms, in our view.

As noted, the central government-owned businesses are mostly in sectors still regarded as strategic, creating a reluctance to relinquish management control to private interests. In addition, the central government has no immediate need for cash injections, and may in fact, be more interested in creating a longer-term revenue streams. This is evident in plans to raise the dividends paid to the central government by the SOEs to around 30% of earnings from the roughly 15% typical paid at present.[5] The situation appears rather different for the local government-owned SOEs.

A number of factors could make more aggressive privatization of local government-owned SOEs more likely than for the centrally owned businesses. The local government SOEs cover a much larger field of activities, many of which are in competition with their more efficient privately-owned peers and are by no means strategic in nature. These ventures have generally been less profitable than the central SOEs. Perhaps most significantly, in our assessment, the poor finances of many local governments represent a strong incentive to monetize SOE assets. Limited revenue sources and a major role in recent investment spending programs have left many local governments with very large debts. Meanwhile, their major source of revenue, the sale of land for development has become less lucrative as property markets consolidate and the practice of expropriating land from farmers with little compensation and then re-selling to developers becomes subjected to greater public scrutiny. Measures are under way to reform local government finances, but privatization revenues could provide a large, immediate source of support.

Well over half of China's provinces and municipalities have announced SOE reform measures of one sort or another since the government's aims were publicized. Guangdong, Chongqing and Shanghai, appear to have more detailed plans than some other provinces. For example, Guangdong was reported in mid-2014 to have offered stakes in 50 different SOEs to foreign investors[6] and to have plans to open 70% of state firms to private capital by 2017.[7] Chongqing was reported in a UK government briefing paper to have offered stakes in more than 100 SOEs to private investors.[8] Shanghai indicated the intention of having some private capital in 60% of its SOEs by 2020[9] and was responsible for some of the more high profile corporate actions to have taken place, notably the injection of private capital into an ailing hotel business and consolidation efforts in the local food retail sector. Elsewhere, the southern province of Hainan indicated plans to open businesses in transportation, construction, energy and tourism to private capital.

In our view, at present, the gap between intention and action appears quite large with local governments and investors some way apart in the valuations that they are placing on state businesses. In one briefing document, the UK government noted that very few of the 100-plus opportunities offered by the local government in Chongqing attracted any interest. We think the gap could be explained as due to an overvaluation by the local governments of their businesses or a lack of enthusiasm on their part for relinquishing control. Another possible reason could be the ongoing anti-corruption drive in China, with price setters reluctant to risk accusations that assets were corruptly under-valued. Among buyers, private equity vehicles in China, potentially a key group of institutions to facilitate privatization, have enjoyed only limited success in recent years with relatively few successful exits and poor capital returns, which might limit the appetite of new investors. Nevertheless, the combination of willing, or even forced sellers and plentiful potential investment capital available, could begin to drive a steady stream of deals, particularly as sellers become more realistic in their pricing while investor familiarity with SOE privatization and regulator recognition of the needs of investors potentially improves. As Free Trade Zones become more firmly established, we believe they could well become centers for privatization. Very recent suggestions that China's domestic stock markets are now becoming sufficiently open to foreign investors to allow their admission to international stock indexes (such as MSCI) may only increase the number of potential foreign buyers.

All in all, we believe that SOE reform in China is likely to progress quite rapidly and that the potential benefits both for China's economy and for investors could be considerable. We will continue to monitor these developments and potential opportunities carefully.

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What are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

1. Source: Economist Intelligence Unit, "Grappling with leviathan: reforming the state sector," 12 January, 2015.

2. Source: *Financial Times*, "China announces plan for reform of state-owned enterprises," 15 July 2014

3. Source: Economist Intelligence Unit, "Grappling with leviathan: reforming the state sector," 12 January, 2015.

4. Source: Reuters, "China plans mergers to cut number of big state firms to 40: state media," 22 April 2015 (quoting Chinese newspaper *Economic Information Daily*)

5. Source: Economist Intelligence Unit, "Grappling with leviathan: reforming the state sector," 12 Jan 2015.

6. Source: *Economist,* “Fixing China Inc.,” 30 Aug 2014.

7. Source: *South China Morning Post*: “Guangdong eyes SOE reform, “29 September 2014.

8. Source: UK Government Foreign and Commonwealth Office briefing paper, “China – State Owned Enterprise Reform,” 7 August 2014.

9. Source: Economist Intelligence Unit, “Grappling with leviathan: reforming the state sector” 12 Jan 2015.