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Two-thirds privatisation: Is it working?

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Summary

- Government-owned entities are deciding to sell their 'legal person' shares in listed firms, mostly to private investors, in ever-greater numbers. Crucially, control rights over the firms involved often change as a result of the transaction. As a result many of China's listed companies are becoming 'two-thirds privatised'. Foreign investors are beginning to get involved too.
- This new market in control rights is enormously significant. In theory, it should create profit incentives at listed firms, harden budget constraints and generally raise the efficiency of listed firms. Moreover, it should allow private companies to gain access to stock market finance (thus promoting the efficiency with which capital is allocated) and it should also help facilitate the consolidation of fragmented industries.
- This briefing note asks a critical question: is this really happening – has the performance of the firms that have undergone 'two-thirds privatisation' really improved? The question is important since a large number of high profile failures have suggested that the answer is 'no', a result that has undermined the case for privatisation. There is, however, good reason to believe that firm performance will in fact benefit, particularly as the regulatory framework for take-overs improves. More sales to foreign investors would be entirely beneficial, despite fears to the contrary.
- In late 2003, a debate within government over whether to encourage LP share deals or to attempt to reduce the state's shareholdings by re-instituting sales of state equity to the public hotted up. This paper strongly supports the former position, arguing that a market-based public sale would now be counter-productive as well as unlikely to improve corporate governance at listed firms. Selling off state shares to the public would not be a politically savvy or economically useful policy, at least not at present.

This Briefing Note is part of an on-going research project into the restructuring of China's listed firms

Introduction

In theory, two-third privatisation should bring positive change to listed firms.¹ Provided that a new private owner has control rights, real profit incentives should be created, budget constraints hardened and the efficiency of the firm's operations improved. The clear lesson of the former Soviet bloc was that firms stand the best chance of improving their performance when control rights are sold to a private investor, though of course these improvements may take some time to become apparent and will need institutional support.²

A number of commentators in China are not so sure. They claim that two-thirds privatisation has, at best, no effect on firm performance and that at worst, allows state assets to be stolen and private investors the opportunity to speculate. Indeed, many acquisitions of listed firms have been subject to manipulation by professional market players and have not led to long-term improvements in performance. One interviewee involved in regulating listed companies estimated that one third of privately-bought out firms experienced an improvement after the private take-over, one third experienced a deterioration, and at the rest there was no substantive impact.³

This is clearly an important issue. Who is right? This brief outlines some of the evidence currently available. It argues that the CSRC is doing a good job of creating a framework in which substantive restructuring takes place and where long-term buy-outs are encouraged. It also examines the current apparent debate over whether government over state share reduction (*Guoyougu jianchi*) or continued LP share sales is the preferable route to improving the market.

Failing take-overs

Cui Hongxia, an analyst at Huatai Finance and Securities, examined the share prices and financial results of some 300 companies that experienced a change in their controlling shareholder between 1997 and 2001.⁴ The findings are not encouraging.

- The new shareholder was not particularly stable. Of the 37 companies that experienced a change in ownership in 1997, 20 experienced another change in ownership within four years. This pattern was repeated in subsequent years. Such a high acquisition turnover suggests that 'fake-acquisitions' (see below) were common.
- Cui also found that post-deal profit growth has declined in recent years. Companies taken over in 1997 experienced three years of profit growth after the change in control and those during 1998-99 two years of profit growth. However, companies bought during 2000-01 did not experience any profit growth in the year(s) following the deal. This may not necessarily be bad news. Many of the earlier deals might have involved restructuring which falsely inflated profits and many of the latter targets might be undergoing more thorough restructuring, thus postponing profit growth. However, the decline is obviously of concern.

In separate analysis, *Xin Caifu* magazine compiled the results of privately-acquired firms in 2001.⁵ For a number of important financial parameters these firms perform worse than average listed firm.

¹ The LP share market is examined in 'Two-thirds privatisation: How China's listed companies are – finally – privatising', Chatham House Briefing Note, November 2003.

² See 'Privatisation in the former Soviet bloc: Any lessons for China?', Chatham House Briefing Note, November 2003.

³ Interview, Shenzhen, September 19th, 2003.

⁴ Cui Hongxia, 'Jinwuniandai wonguo shangshi diyi da gudong gaibian de shizheng fenxi [An analysis of changes to the controlling shareholding in listed company in the last five years]', *Huatai Caijing Zhengquan Fenxi*, June 2002, pp. 2-10.

⁵ Lang Xianping and Zhang Xindong, '100 jiazu [One hundred family groups]', *Xin Caifu*

- Their return on equity (ROEs) was lower than the average: 4.9% compared to an average of 5.2%.
- Their debt ratios were higher: 78.6% compared to an average of 43.6%.
- Their dividend payments as a proportion of profits were a third of the average rate of 15.6%.
- The cash component of their net profits was one half of the average (90.1%).
- The value of their receivables as a proportion of gross assets was high, some 50% higher than the average 16.2%.

These are figures to depress even the most optimistic of privatisers, though, as argued below, they do not necessarily signal that acquisitions are failing to turn around firm performance.

But why might they be doing just that? The suspicion is that many deals are organised in order to manipulate the target firm's share price. A buyer will buy listed shares, then a chunk of non-tradable shares, and make seductive promises of restructuring. Once the listed share price has risen (and the buyer has sold its holdings), the restructuring plan will be forgotten.

A more recent evolution of the scam has been to go a bit further in restructuring, and then to use the listed company to guarantee a bank loan or to apply to the CSRC for a rights issue.⁶ Once this has been done, the majority shareholder sets about stripping the listed firm of this capital (perhaps through a cash dividend or a related party transaction) and the listed firm's performance would, once again, deteriorate.

Before 1998, there were some 120 transfers of corporate control at listed firms – but at least 40 of the firms involved have since experienced a second (some even a third) change in controlling shareholder – evidence that the firms were being used for such short-term speculative purposes. This is having serious consequences. An interviewee in July 2003 remarked that provincial governments were less keen on private take-overs in mid-2003 than they were during 2001-02 since several of them had failed to rescue the listed firm.

As well as fake acquisitions, another problem has been 'desperate M&As', those organised in a last-minute attempt to rescue a firm from a transfer to the ST or PT categories or even a delisting. The amount of acquisition activity on the two boards tends to increase in November and December, as the annual accounts season nears. Although there have been cases in which these have produced viable firms, more often than not the expense involved in organising the buy-out outweighs the benefits derived.

One other different criticism of the LP share market is that it abuses the private sector. It is private firms, deprived of a listing place in their own right, which have to buy-out defunct state firms in order to gain access to the stock market. Buying and restructuring a listed ex-SOE is, of course, a costly and inefficient exercise. Private enterprises are in effect being taxed to gain entry to the stock market.

Successful take-overs

Research by Dongfang Gaosheng Gaolei (DGG), a consultancy, suggests that things are improving.⁷ It looked at 26 listed companies whose controlling shareholders changed twice between 1996 and year end 2001. The first time around the firms' average ROE doubled from 5.4% before the acquisition to 10.0% in the year after it. But after this ROEs declined rapidly. Assets had been inserted and debts transferred out, but no fundamental change in the operations of the company had followed. By the time of the second take-over announcement,

⁶ A rights issue can be applied for as soon as an acquired firm has registered a net profit.

the average ROE had declined to 2.1%. It was clear that most of the deals were fake or poorly planned.

The second round of acquisitions provided greater cause for optimism for a number of reasons:

- ROEs rose to 11.2% in the first year after the deal and then appeared to stabilise.
- Over two-thirds of the companies involved underwent major asset restructurings, a sign of greater commitment on the part of the buyer to the listed firm.
- Fewer investment companies and more firms with substantive businesses were involved in these deals, suggesting that a backdoor listing rather than a speculative play was the motive behind the deal.
- The second set of take-overs tended to be priced at a higher premium to the NAV of the target than the first set. This could suggest a greater seriousness about the purchasers' intentions since they are risking more of their own capital in these deals.

Research by Zhang Xin, a professor at Beijing University, has also found improvements in firms' performance after such take-overs. He looked at profit rates at companies that were bought between 1998-2001, finding that they rose from an average of 23% in the year of the deal to 26% two years later. He argues that this suggests that a private acquisition has a beneficial, long-term impact on the performance of listed firms.⁸

It is also worth taking a second look at the *Xin Caifu* data – because the picture is not as bad as the figures initially suggest.

- There is a problem with selection bias, since firms that were acquired were below-average performers before their buy-outs – and were acquired oftentimes for this exact reason.
- Some of these statistics are entirely normal for a firm that has just acted as a backdoor listing vehicle. The high debt ratio, for instance, reflects the debt that was required to finance the take-over itself (since the indebted buyer usually inserts itself into the listed company). The low level of dividend payments may reflect efforts to invest income rather than distribute it to owners, a rational act for growing companies.
- The figures are not all bad. Profits from the main business operations appear to be strong (26.4% compared to an average of 23.3%). These are the businesses that have been inserted by the new owner, and this figure is one of the best indicators of long-term performance.
- The majority of acquisitions have taken place during 2000-02, and it is too soon in many cases to properly evaluate how successful they have been, particularly as the regulatory framework improved during this later period.

There is also much ad hoc evidence that buy-outs can work to transform listed firms. Some 35 of the 100 companies that analysts at *Xin Caifu* magazine viewed had the best growth prospects in August 2002 had undergone a take-over and/or significant asset restructurings in their recent past.⁹

And, although as noted above, private enterprises are taxed to gain a stock market listing, the policy does have a certain logic behind it. First, it means that private capital is made available used to subsidise the restructuring of state firms (and meet some of their welfare liabilities), something the government's own budget can not support. Second, and more productively, the

⁸ Zhang Xin, 'Regulating Chinese M&A', *Finance Asia*, August 29th 2002.

⁹ Lang Xianping and Zhang Xindong, '100 Jiazu [One hundred family groups]', *Xin Caifu*

high entry barriers means that buyers are likely to work for the long-term good of their acquisition.

Regulating take-overs better

There are a number of reasons to hope that acquisitions are increasingly likely to lead to substantive restructuring and thus improved performance. First, the decline in market prices during 2001-03 has reduced incentives for manipulation-based buy-outs: with prices so low it is extremely hard to make money on such scams.

Second, and more importantly, the CSRC has introduced a series of rules that restrict manipulation and create incentives for quality restructurings. Most importantly, in September 2002, the CSRC issued the Listed Company Merger and Acquisition Management Measures (hereafter M&A Regulations), which laid out the first substantive framework for M&A.¹⁰ Amongst the measures currently being taken are:

- Fakes M&As are being investigated and punished. Those involved in one infamous case, *Zhongke Chuangye*, were put on trial in the summer of 2002, the first stock market-related crime to reach a criminal court. (The case has not yet reached conclusion due mainly to the absence of the two main protagonists.)
- In May 2002 the regulator established a 'restructuring authorisation committee' to oversee applications for LP share purchases of more than 30% of assets. In addition, it now requires deals involving the transfer of more than 50% of the assets of a listed company to be authorised by the committee. This is aimed at filtering out 'fake' M&A deals and preventing asset stripping.
- The CSRC introduced tougher tender offer requirements in its M&A Regulations. A tender offer is now required after a shareholder had bought 30% of a listed company and intends to buy more shares. This raises the risk that a buyer will have to offer to buy other shareholders' shares, increasing the financial cost of a take-over and thus disincentivising short-term speculators.¹¹
- According to interviewees the CSRC has recently instituted a new informal policy of not authorising the transfer of large non-tradable stakes within a three-year period after their transfer.¹² This will act to prevent short-term take-overs.

The M&A process is still vulnerable to abuse, however, and while the CSRC appears to be relatively successful in preventing the worse abuses there is, of course, room for further improvement.

A question mark hangs over the suitability of the sale method predominantly used: one-to-one negotiated transactions. Alternatives include:

- Auctions. These would be a more transparent and fairer way of organising many of these sales, at least those deals which do not require detailed negotiations between buyer and seller over such issues as employees, liabilities, contracts etc. One-off auctions of large blocks of LP shares could be organised at the Property Rights Transactions Centres (PRTC's).
- A centralised trading system where LP (and perhaps even state) shares could be freely traded by LP entities. This system might be hosted by one or both of the two stock

¹⁰ In Chinese *Shangshi Gongsi Shougou Guanli Banfa*, issued September 28th 2002. The September regulations also expanded the type of borrower to any legal entity and individual and enlarged the type of financing that could be used in the acquisition, now including cash, share swap, secondary issues.

¹¹ The regulations laid out five situations in which a buyer might apply for a CSRC exemption to the need to make a tender (arts. 48-53) but this exemption is in the CSRC's gift.

exchanges, or it might be hosted by one or more of the PRTCs. Another proposal foresees the merger of these PRTCs into one national trading system. This might work as an intermediate step towards floating the shares in the individual share market. It would enforce greater transparency, facilitate trade and rational price formation (as well as probably leading to higher prices for state assets). On the negative side, it would mean the establishment of yet another distinct share market and considerable tensions between the CSRC and the SASAC.

State shares reduction versus LP share sales: which way to go?

During October-December 2003, a debate within government over whether to encourage LP share deals or to attempt to reduce the state's shareholdings by re-instituting sales of state equity (*Gouyougu Jianchi*) to the public erupted. The market responded positively in early December, with price rises, as analysts speculated that movement on the state share issue would mean that the government would also need to institute policies that pushed prices up; a 'sterilisation' policy, in other words.

One of the proposals involves listed companies self-selecting themselves for converting their state shares into tradable shares, then either selling them into the market or transferring them to current shareholders. In some versions of the proposal this involves majorities of both individual shareholders and non-tradable shareholders agreeing in votes to the conversion. The proposal has certain merits. It allows owners to decide what happens to the companies they own, thus reducing the dominance of government policy. These are, after all, shareholding companies that in theory operate independently of government. The proposal also, in theory, creates a control mechanism on the flow of companies that will sell their state shares.

Other proposals have attempted to control the flow of state share sales in other ways. One for instance, involves allowing companies that listed first to sell their non-tradable equity first. However, the proposal above has the advantage of empowering shareholders in such a crucial decision. Putting the decision to a shareholder vote should also reduce the impact of a sale decision on a share price: since shareholders themselves will decide what to do. If they vote to convert then presumably most will not then sell their shares.

For reducing the state's influence over listed companies, such proposals are to be welcomed. However, as this Briefing Note has argued, state share reduction might not be all that necessary for improving firm performance. Consider these factors:

- First, what is crucial for performance is transfer of control, and the LP share deals often accomplish this. As long as state shareholders remain passive, then the issue can be ignored, at least for the time being.
- Second, selling state shares into the open market would not result in control rights changing hands, but rather dispersing. A large body of research shows that companies with dispersed shareholdings do not perform as well as those with a small group of controlling shareholders. Collective action problems set in with dispersed ownership, leaving the firm rudderless. The important thing for good corporate governance is transferring control rights into private hands, which the LP market is already achieving.
- Third, any proposal to sell state shares is risky. However you frame the proposal to minimise the impact on share prices, there is a chance that it will have a negative impact. There are huge and not-well understood interests involved in the stock market who would lobby furiously against any such move. Retail banks are thought to be exposed to share prices (through loans to corporates, and now to individuals), as are SOEs, securities firms and investment funds. Many government officials, and their relatives, are thought to have money in the market. Thus, it is politically very difficult to win agreement at senior levels on a state share sell-off. Why expend so much political capital when the positives are so limited. Why take the risk?

The Briefing Note therefore supports the further development of the LP share market. A public sale of state shares would be politically risky, as well as unlikely to improve corporate governance at listed firms. As long as state shareholders remain passive – a bid if, admittedly – and as long as the regulatory framework for the LP share market can increase incentives for long-term investment by those acquiring listed companies, then two-thirds privatisation via LP share deals is something to be supported.

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