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# 'Two-thirds privatisation': How China's listed companies are – finally – privatising

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***Summary***

- China's stock market is slowly privatising. State-owned enterprises initially only sell about one third of their equity capital to private investors – and thus became 'one-third privatised'. Such restructuring is designed to improve the firms' performance while allowing the state to retain control, but has widely perceived to have failed – the efficiency of the majority of listed companies has declined after listing or improved only marginally.

- This failure, combined with increased regulatory scrutiny by the China Securities Regulatory Commission, has altered the incentives facing state shareholders. No longer can these shareholders so easily profit from manipulating the share price of, and stripping assets from, their listed companies.

- As a result, they are deciding, in ever-greater numbers, to sell their 'legal person' shares, mostly to private investors. Crucially, control rights over the firms involved often change as a result of the transaction meaning that many of China's listed companies are becoming 'two-thirds privatised'. Foreign investors are beginning to get involved.

- This trend is enormously significant. It should create profit incentives, harden budget constraints and raise the efficiency of listed firms. 'Two-thirds privatisation' also opens up a new route for private companies to gain access to stock market finance; it should facilitate the consolidation of fragmented industries; and it may even show how state shares, the final third of listed companies' equity, can be successfully sold off.

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

## Introduction

China is in the midst of a gradual and messy programme of privatisation. Evolving haphazardly in form over time, lacking any overarching plan and still constrained by the Party’s formal ‘socialist’ ideology the approach of the People’s Republic of China to the privatisation of its state-owned enterprises (SOEs) is unique (as explained in a previous Briefing Note, ‘Will privatisation in China work?’). Since the mid-1990s tens of thousands of small- and medium-sized SOEs have been restructured, sold off, closed down, or leased out. Many have been privatised.

The experience of the large- and some medium-sized SOEs that have restructured into shareholding companies and publicly listed their shares has been very different. About 1,110 of the 1,224 companies listed on the Shanghai and Shenzhen stock exchanges (hereafter SHGSE and SHZSE respectively) at year end 2002 began their corporate lives as SOEs, owned wholly by the state (and, in theory at least, by the people).

Beginning in the late 1980s, they were restructured into shareholding companies in which property rights were created in the form of shares. The parent SOEs (which themselves often also restructured into shareholding companies) became controlling shareholders and a small amount of equity was sold to the public. In effect these companies were ‘one-third privatised’. The clear aim was to facilitate the transfer of private funds to what remained, in essence, state-owned companies. Some 1,150 ‘one-third privatised’ SOEs received some Rmb840bn ($101bn) in investment capital via initial, rights and secondary share issues up to year end 2002, an average of Rmb730m ($88.0m) each.

For most of the 1990s, this was the limit of privatisation for China’s listed firms. However, further change has occurred since 2000, as increasing quantities of state-owned shares have been sold to non-state entities. According to China Securities Regulatory Commission (CSRC) research, by the end of 2002 some 338 listed companies had experienced a change in control. A large number of listed companies are now ‘two-thirds privatised’ – another third of their equity having been sold into private hands – and it seems only a matter of time before the final third is also put on the block.

This Briefing Note first reviews the first two stages of this enterprise reform process – incorporation and share issuance – and then turns to the new market in LP share sales, explaining why their owners sell, why their purchasers buy and how the deals are organised. The final section outlines why they are important.

## One-third privatisation: incorporation and public share issuance

How does a SOE become a shareholding company? In many cases a new company limited by shares was established as a wholly-owned subsidiary of the SOE of which it was originally a part. Profit-generating assets are then transferred into the shareholding firm while social-welfare functions (such as schools and clinics) are placed in other units of the group, and/or sold off. The incorporated company then issues shares to the parent enterprise (in return for the assets it has contributed), as well as in many cases to its employees (often at this time in lieu of wages) and the public. These are when LP shares are created.

In most capital markets, developed and otherwise, the common shares that companies issue confer specific rights on their owners, primarily the right to vote at shareholders’ meetings, to receive a share of the company’s profits in the form of dividends and to sell the shares if the owner so wishes. All owners of common shares enjoy these rights and are treated equally in most circumstances.

Policy makers in China, in marked contrast, have encouraged the balkanisation of share types in order to pursue their policy ends. In May 1992, two notices were issued that set the

first national standards for China’s share market. The categories of individual, legal person (LP) and state shares were thus created (and have endured to the present day).

- **Individual shares (*geren gu*)** are the only sort of share that can be listed on the stock exchanges, owned by individuals and openly traded.
- **State shares (*guojia gu*)** are created though the injection of state-owned assets from authorised government organs acting on behalf of the state. State shares are owned ultimately by the State Council and are currently managed by the State-owned Assets Supervision and Administration Commission of the State Council (*Guowuyuan Guoyou Zichan Jiandu Guanli Weiyuanhui*, hereafter SASAC) and local state asset management bureaux.
- **LP shares (*faren gu*)** are, in contrast, issued to LP entities in return for the injection of assets. If the LP shareholders are state-controlled entities (including those enterprises in which the state has more than a 50% stake) and contribute state-owned assets to the restructured enterprise then the LP shares they receive are ‘state LP shares’ (*Guoyou faren gu*). In contrast, a company may also issue LP shares to non-state investors who contribute non-state assets and these shares become standard LP shares.

By the end of 2002, only 6% of listed companies had non-tradable shares accounting for less than 40% of total equity capital, while only 0.4% of listed companies had no non-tradable shares at all.

This balkanisation of share categories has created a number of problems. Despite official claims to the contrary, different shareholders have clearly been endowed with different rights. Individual owners of A-shares are discriminated against in terms of pricing: they pay more for their shares than LP shareholders who are allocated their shareholdings prior to the IPO at prices close to net asset value (NAV). Other problems arise too with one shareholder dictatorships.[1]

## Two thirds privatisation: the market for legal person shares

Until January 1996, there were only 12 reported cases of the controlling shareholders of listed firms changing through the transfer of non-tradable shares. In contrast, from 1996 to year end 2001, there were 320 cases of listed firms experiencing a change in their controlling shareholder. The number of such increased dramatically during 2002-03. 14.7% of listed companies in 2002 experienced a change in their controlling shareholder. (It is important to note that these deals are not synonymous with privatisation, even of the two-thirds variety, since some of the new owners were not privately-held companies.)

Why is the market for non-tradable shares developing so rapidly? There are six main reasons.

- **Other strategies, including asset restructurings, are failing to produce sustained improvements in firm performance.** Starting in 1997, China’s stock market experienced a spate of restructuring. However, newly inserted assets were often ill-suited to the listed firm or over-valued. Management was often not replaced and it is difficult to build a successful business on the basis of assets that no one in the company has experience of operating. Many of the “new economy” restructuring deals announced in 1999-01 were unrealistic, and a large number were little more than elaborate con-tricks. With few prospects of a reliable dividend in the near future, the incentives for LP owners to sell their holdings in order to realise an immediate cash sum have increased.

[1] The problems are examined in S. Green, *China’s Stockmarket: A Guide*, London: Profile Books, 2003, pp. 118-152.

- **Further improvements in the regulatory environment since 2000 have encouraged LP shareholders to quit.** The CSRC has also got better at investigating and tougher in the administrative punishments it levies. The regulator has also taken direct measures to weaken the power of LP shareholders, making asset stripping less easy. A delisting mechanism has been rolled out by the CSRC and the government is increasingly at ease with bankruptcies (although no listed firm has yet undergone one), raising the possibility that LP shareholders will lose their firms entirely.

- **Shareholders themselves have become more active in pursuing managements who commit illegal acts** and the government has given them space to do so by making them financially and criminally liable for the accuracy of their financial disclosures.

- **More active institutional investors.** Fund managers and institutional investors are now becoming active in monitoring firm managements and acting if they believe that shareholders value is being damaged.

- **Facing hardening budget constraints, the owners of non-tradable shares are under pressure to raise capital.** Soft budget constraints for SOEs were hardened in the late 1990s, as budgetary subsidies were squeezed and the banks became better able to resist political pressure to lend to state-controlled firms. Faced with the need to raise working capital, one obvious route is to liquidate assets and if LP shares are not generating dividends there is little reason not to sell them.

- **A class of private buyers has emerged.** During the 1990s private firms grew considerably in size and financial resources, enabling them to buy listed companies with retained earnings, savings or loans from other companies. One example is the Delong Group. Since 1992, the Tang Brothers have acquired control of four listed companies, Hejin Touji (Stock code: 000633), Xianghuoju (000549), Xinjiang Tunhe (600737) and ST Zhongyan (600763).

## How are LP shares purchased?

Transfers of LP and state shares can occur in a number of ways. Table 1 shows a breakdown of the 130 deals in which control rights changed hands in 2001.[2]

**Table 1. How control at listed companies changed in 2001**

| | *Agreed sale* | *Free transfer* | *Indirect take-over* | *Judicial transfer* | *Shares entrusted* |
|---|---|---|---|---|---|
| Number of companies at which control changed hands | 88 | 27 | 4 | 11 | 4 |
| Proportion of total transfer deals, % | 66 | 20 | 3 | 8 | 3 |

Source: Nie Zurong and Xiaoqi Tian, ‘Kongguquan Chongzu--2001 nian Woguo Zhengquan Shichang Maike Jieke Tongji Fenxi Baogao [Restructuring Corporate Control: A Statistical Analysis of the 2001 Market in Shells], in *Changjiang Zhengquan 2001 Baogao* [*Changjiang Securities 2001 Report*], Wuhan, 2001, p. 306.
Note: This table only includes deals in which control changed hands.

[2] An alternative set of numbers is provided by Green, S. & Black, A. ‘A market in control: non-tradable shares deals in companies listed at the Shenzhen Stock Exchange’, Chatham House Working Paper, December 2003.

- **Agreed sale (*xieyi zhuanrang*).** The most common type of transfer is an agreed sale, which usually involves a company, often private, buying LP shares for cash from a state LP shareholder.

- **Free transfer (*guquan zhuanran* or *wuchang huabo*).** About one fifth of the changes in corporate control in 2000 and in 2001 – less than in previous years – involved the administrative transfer of shares from one government organ to another.

- **Indirect take-over (*jianjie konggu*).** This involves company A, which has a LP share stake in company B being taken over by company C. Company C thus assumes control of company B. This process can also result in two-thirds privatisation if company C is a non-state concern and company A is a state-owned venture.

- **Judicial decision (*sifa caiding*).** One in ten of the changes in ownership in 2001 involved the transfer of shares as a result of a court judgement. This usually involved an insolvent LP shareholder being forced to sell the shares at auction after which the revenues are collected by the creditor(s).

- **Entrusted shares (*zichan tuoguan*).** Buying listed companies is a complicated and risky business. Taking charge of the shares under a trust agreement, in which the purchasing firm pays a fee to manage a controlling stake in a listed company is a useful, and increasingly popular, halfway house. It gives the interested buyer an opportunity to ‘road test’ the firm and to examine its business and books in detail. During 2003 it appeared that the CSRC introduced some restrictions on this type of transaction to prevent buyers by-passing the need to seek government approval for a state entity sale of shares to a private investor. All such LP deals require this permission.

## Who buys LP shares and why do they do so?

There are a number of reasons for organising a buy-out. For instance,

- **State-controlled firms discriminated against in the national investment plan seeking a backdoor listing.** Since 1992, the State Planning Commission has determined that firms in sectors such as utilities, infrastructure, telecommunications, natural resources, should receive favoured access to the stock market. In contrast, firms operating in financial services, light manufacturing and real estate have been excluded or discouraged from listing, forcing them to make acquisitions to accomplish their listing ambitions. In tobacco, for instance, the Hongta Group purchased the listed firm Kunming Jichuang; Kunming Juanyanchang purchased Kunbaida; and Shanghai Yancao bought control of Jielong Industries.

The majority of buy-outs involve a private (*minying*) firm as buyer, however. They have a variety of motives.

- **Investment firms buy control of listed companies in order either to restructure and sell it on or to manipulate the share price.** 22 of the 70 purchases in 2001 were made by investment companies, firms without substantive businesses specialised in taking over a company and re-inventing it. While some of these deals are undoubtedly substantial, many of them fail either to endow a firm with a new business or to manage it through the required transition to profitability. The suspicion is that many scams have been organised by investment companies which are often little more than fronts for stock manipulators, the classic example being the *Zhongke Chuangye* scandal.

- **A few listed companies have attractive assets that a private purchaser believes it could make profitable use of.** As in more mature markets, the buyer might wish to benefit from the resulting economies of scale created by acquiring a competitor, gain additional market share, absorb technology or poach skilled personnel. Alternatively, a buyer might acquire another firm in order to absorb new products or functions into his

firm, anything from research to distribution, because of a growth opportunity or a means to diversify risk. Taitai Pharmaceutical's take-over of Lizhu Pharmaceuticals in 2002 is a prime example of this.[3]

- **The majority of private firm purchases, however, are driven by the desire to obtain a listing.** The targets of most take-overs do not generate profits, are over-staffed, heavily indebted, lack valuable assets and operate in sunset industries. In other words, they present an unattractive take-over target. Their key asset is their listing place.

In theory, private firms in China now enjoy equal treatment with restructured SOEs in their applications for a public listing. However, despite a small trickle – some 57 of the 1,160 listed companies by year end 2001 – it remains hard for them to win a listing place in their own right. According to a senior official at the SHGSE, by March 2003 about one in five of listing companies were private. Other interviewees thought this figure too high.

Despite the elimination of the quota system in 2000, the CSRC retains the right to approve new listings and once the committee has passed an application, the CSRC decides when it issues shares (and where it lists). Political pressure in favour of former-SOEs is present at every stage of the application process. Moreover, there are relatively few listing places available each year – just over one hundred each year during 1997-2000, and around 70-90 a year since 2001. According to interviewees, by September 2003 about 70-90 firms had received permission to list but could not do so because of the perceived lack of investor demand. Another 2-3,000 firms were thought to have applied for a listing or to be going through the one-year preparation for listing period. The large majority of these firms are former SOEs.

The result of these constraints is that many private enterprises chose to make a back-door listing in order to gain access to stock market capital. Once they have taken over a listed enterprise, and have satisfied the CSRC that the restructuring they are organising is profitable, the 'new' firm can apply to make a share issue after only one year.

## Why are LP share sales important?

Not all LP share transactions lead to two-thirds privatisation – but the majority appear to do so. These deals are important for a number of reasons:

- First, two-thirds privatisation should result in firm-level efficiency improvements. All else being equal, private control should result in better performance at these firms as profit motives are introduced, budget constraints hardened and administrative interference in firm operations are reduced. A previous Briefing Note ('Privatisation in the Former Soviet Bloc: Any Lessons for China?', November 2003) explains why ownership change is so important.

- Second, as the acquisition market develops, fragmented industries will benefit from consolidation. Cross-provincial LP share deals are already occurring, allowing the development of national private industrial groups.

- Third, these share sales are allowing greater numbers of private firms to gain access to stock market finance as listed ex-SOEs are used as backdoor listing vehicles. This is a positive trend since it will allow the most dynamic part of China's economy access to a valuable source of investment capital to which it has been previously excluded.

[3] The Lizhu/Taitai deal is examined in detail in a recent Chatham House Working Paper, Stephen Green & Jenna Ho, 'Old stocks, new owners: Two cases of ownership change in China's stock market', Asia Programme Working Paper, No. 9, Royal Institute of International Affairs, October 2003.

- Fourth, together with the liberalisation of investment rules set in motion by concessions made to join the World Trade Organisation (WTO), the development of China’s merger and acquisition (M&A) market should serve to attract greater foreign direct investment. While the QFII system has been criticised for the onerous restrictions it imposes on foreign investors, and the listed A-share market criticised for its expensive valuations, the acquisition of LP shares are cheap and subject to few administrative restrictions. It should thus be of greater interest to foreign investors.

A following Briefing Note considers whether in fact two-thirds privatisation is having a positive impact upon listed firms.

This briefing note is based on a China Project Working Paper. Future Briefing Notes will examine other aspects of this new market in LP shares.

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