Old stocks, new owners: Two cases of ownership change in China’s stock market

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Old Stocks, New Owners: Two Cases of Ownership Change in China’s Stock Market

Abstract

During the 1990s, ownership of China’s listed firms remained stable: state entities remained in control of former state-owned enterprises since only a minority of shares were allowed to trade publicly and to be owned privately. However, since 1999 the ownership of China’s listed firms has become more fluid due to the development of an off-exchange market in ‘legal person’ shares. This paper examines two such cases of ownership change. The case of Taitai’s take-over of Lizhu shows that transfer of control is now occurring on a commercial basis. However, the Baiwen case shows that buy-outs are still organised by government entities to support failing state firms. This suggests that industrial policy is (albeit slowly) adjusting to market disciplines. Both deals involved relatively complex buy-out strategies and suggest that the government is both using all and any means to restructure listed firms, rather than delist them, and also moving to create a competitive market in control.

Key words: China, Economic Development, Stock Market, Acquisition, Restructuring, State-owned enterprises
Introduction

During the 1990s, the ownership of China’s listed firms remained stable – state-controlled parents usually retained control of their partially-privatised subsidiaries via holdings of legal person (faren gu, hereafter LP) shares.\(^1\) These shares could not be listed on the stock exchanges and little transfer of them occurred before 1999. Since firms only issued a small proportion of their equity, usually less than 30%, as individual (geren) shares, the only type of equity authorised to freely trade, China’s stock market was not a market in control rights. However, since 1999 ownership has become much more fluid due to the development of an off-exchange market in LP shares.\(^2\) These shares can now be sold to another legal entity, state-controlled or otherwise, often with the active support of the local provincial government and with minimal regulatory involvement from central government organs. Most LP share transfers simply require an easy-to-obtain stamp of authorisation from the Ministry of Finance (MoF). Since LP share transfers often occur in large blocks, they often endow the new owner with control.

This paper considers two cases of ownership change among China’s state-controlled listed firms. The two cases differ in a number of important respects. Zhengzhou Baiwen was a classic old, inefficient, diversified state-owned enterprise (SOE) that had gone through a superficial restructuring to convert into a shareholding firm and had had its accounts ‘packaged’ (baozhuang) in order to allow it to list shares publicly in 1996. After its large losses had been discovered in 1999, it faced bankruptcy. However, instead of being closed Baiwen was rescued through a deal organised by the firm’s owner, a local industrial group controlled by the Zhengzhou city government. The buyer, Sanlian Group, was also a state-controlled company, albeit one based in a different province. Sanlian appears to have been motivated by a desire to win control

\(^1\) A listed company was usually ‘carved out’ of an SOE, its productive assets being inserted into the listed subsidiary and non-productive assets being placed in the parent, the later taking LP shares in the listed vehicle. Individual shares (tradable shares), state shares and LP shares each make up approximately one-third of a listed company’s equity capital. State shares can not be listed or freely traded, and their transfer is subject to approval by the MoF. LP shares can not be listed, and can not be traded in the market though they are now relatively easily transferred in one-to-one deals. For an introduction to share types, see Green, S, *China’s stockmarket: A guide to its progress, players and prospects*. London: Profile Books/The Economist., 2003, pp. 15-18. On SOE restructuring, see Huchet, J.F., and X. Richet ‘Between bureaucracy and market: Chinese industrial groups in search of new forms of corporate governance’, *Post-Communist Economies* 14 (2), 2002, pp. 169-201.
of a stock market listing for its own operations – and attracted by the subsidies inherent in the state-sponsored rescue deal. The transfer was complicated by the fact that Baiwen’s shares were dispersed among a large number of individual shareholders, and so an innovative, complex – and initially contentious – deal in which all shareholders gifted one half of their shareholdings to Sanlian was worked out.

The second deal involved the take-over of Lizhu, a successful state-controlled pharmaceuticals concern by a private firm, Taitai Pharmaceuticals. Taitai had – unlike most other private firms – won its own listing place on the Shanghai exchange via an IPO rather than an off-market purchase of LP shares. The take-over was not motivated by the failure of Lizhu (as was the case in the Baiwen and most other LP share buy-outs), but rather its success – Taitai wanted to absorb Lizhu’s marketing network and product range into its own business. The deal was complicated, however, by Lizhu’s relatively dispersed shareholding structure. Moreover, Taitai was forced to compete to gain control of Lizhu via an open competition to buy its non-tradable as well as tradable shares. The structure of control that Taitai ultimately created over Lizhu depended on a complex system of cross-holdings by Taitai’s affiliates and subsidiaries.

By examining these two case studies of listed firm buy-outs in detail, this paper aims to illuminate China’s evolving acquisition market – its regulatory framework, the varied motives of buyers and sellers, the stance of government owners and the conflicts of interest that arise. It reveals a number of new trends in the market. First, there is increased transfer of control of listed companies. These are only two of the 100-or so transfers of control which are now occurring each year. Many transfers are occurring on a commercial basis, a sign that bodes well for the future of listed firms as the chances that assets will end up with productive owners are raised. Second, however, the Baiwen case reveals that protection from market disciplines and state subsidies are still playing an important role. The Baiwen deal was a government-sponsored rescue which depended on the bending of regulations and the creation of artificial incentives for Sanlian to engage. This was an improvement on older methods

2 The LP share transfer market is examined in Green, S. forthcoming, 2003. At last privatisation: China's stock market and new trends in industrial reform: Royal Institute of International Affairs.
of listed company rescues – direct subsidies, soft bank lending or an administrative transfer of control – and thereby suggests that industrial policy is slowly adjusting to market disciplines, though not yet fully. Third, both deals involved relatively complex buy-out strategies. One involved the exertion of control over the listed firm via holdings of different categories of shares by different parts of a single enterprise group. The other deal involved an innovative approach to consolidation of shares by using a free share transfer plan. Fourth, the China Securities Regulatory Commission (CSRC) is acting to facilitate listed company take-overs, both market-based ones and those organised through administrative means.

The first two parts of the paper examine the Baiwen and Lizhu acquisitions in detail, and the concluding section assesses the efficacy of the current M&A framework, and point to areas in which it could be improved.

**Rescuing Baiwen**

Zhengzhou Baiwen (stock code: 600898), formerly known as Zhengzhou City Department Store and Cultural Products Company (Zhengzhou City Baihuo Wenhua Yongpin Gongsi), listed on the Shanghai Stock Exchange (SHGSE) on April 17th 1996.³ It manufactured household appliances and operated several department stores in Zhengzhou City in Henan province. Three years after its listing it was discovered to have been systematically faking its accounts. It was then confined to the Special Treatment (ST) category on March 27th 1999, and after a failure to improve, to the Particular Transfer (PT) category on February 2nd 2001 by the regulator, the CSRC.⁴ An investigation into the firm’s accounts revealed losses of over Rmb500m ($60m) in 1998 and Rmb980m ($118m) in 1999.⁵ Accumulated losses by the end of June 2000


⁴ Baiwen’s questionable accounting practices are described by Zhu Defeng, ‘PT Zhengbaiwen liangnian nianbao ruhe kan’, Zhongguo Zhangquan Bao, February 10th, 2003, sourced from http://news1.jrj.com.cn. Baiwen was the first listed company to have senior managers face criminal prosecution for false accounting practices. The company was fined Rmb2m (240,000) and two managers were fined Rmb300,000 ($36,200) and Rmb200,200 ($24,000) each. Such was normal practice for such an offence. However, in early 2002 the two were charged with false accounting, a crime which carried a maximum penalty of three years in prison, in addition to a fine of Rmb200,000 ($24,000).

⁵ This translated into a per share loss of Rmb2.54 in 1998, a record loss for a listed firm in China. One of the many tricks Baiwen used to disguise the try state of its financials was ‘fake’ sales to related companies. Baiwen and a friendly firm would sign a sale agreement, allowing Baiwen to log receivable income from a friendly company while neither side had any intention of carrying through the sale.
totalled Rmb1.8bn ($217m); the firm then had a per share net asset value of –Rmb6.88.

Any company registering two years of losses or other major problems is transferred to the ST category (an additional year of losses taking the firm into PT). ST/PT firms are given time to restructure. However, because of the entirely rational expectation among investors that they likely will be subject to a local government-led rescue bid, ST/PT firms are often the focus of much speculative trading activity. The share price of a firm will more often than not rise, rather than fall, when it enters ST. In an attempt to improve such incentives, since 2002 the CSRC has moved to gradually eliminate the PT category altogether by introducing an automatic trigger for a delisting once a company has recorded three years of losses. In Baiwen’s case, the move to ST/PT triggered a conflict over its future: bankruptcy or restructuring.

In December 1999, China Cinda Asset Management took responsibility of Rmb1.9bn ($230m) worth of Baiwen’s non-performing loans (NPLs) from the China Construction Bank. After carrying out an assessment of Baiwen’s operations and its ability to service its debts, on March 3rd 2000 Cinda applied to the Zhengzhou Intermediate People’s Court for Baiwen’s bankruptcy and liquidation. A common criticism of the AMCs is that they have not had sufficient political support to enable them to sue for the bankruptcy of highly-indebted companies, a reasonable strategy given a moribund company. Instead, usual practice has been for AMCs to convert debt into equity, a move whose efficacy is undermined by the fact that the AMC is not often able to take a seat on the board, let alone direct the firm’s operations. It was a sign of Baiwen’s poor finances, and even worse future prospects, that Cinda filed for the firm’s bankruptcy. However, the bankruptcy was resisted by local government officials who appear to have effectively stalled proceedings in the city court.
Old Stocks, New Owners: Two Cases of Ownership Change in China’s Stock Market

officials were also probably reticent to instigate the first bankruptcy in reform China of a listed firm.

Given the stalled bankruptcy, the city government, working with management, moved to work out a restructuring plan to rescue Baiwen – and to find a rescuer who could provide the requisite assets to turn Baiwen round. Highly indebted and with a value-destroying business, Baiwen was an exceedingly poor investment proposition. What was really on offer was the firm’s listing place, a valuable asset since only some 100 companies receive the CSRC’s permission to publicly list shares each year, and the application process for an IPO listing takes at least three years. However, such were the scale of Baiwen’s liabilities and fears of more debts being discovered that a number of corporate suitors came and, after examining the firm’s accounts, declined to buy the firm.

Finally, after one year, on January 18th 2001, the firm’s board of directors passed a restructuring plan that would deliver control of Baiwen to the Sanlian Group, a state-owned shareholding firm from Shandong province. The structure of the deal they proposed had not been tried before, and was to be extremely difficult to implement. Normally a restructuring is effected simply by transferring a single large chunk of LP shares from their old owner to a new buyer. However, in this case the restructuring was complicated by Baiwen’s relatively dispersed shareholding structure. Its top six shareholders held only 28.9m shares, some 14.6% of the total, as Table 1 shows. Baiwen’s parent company, the state-owned Zhengzhou Baiwen Group, was the only shareholder with a stake of more than 10%. This meant that the restructuring plan had to somehow facilitate the concentration of these, and other, shares in the hands of the new owner. Moreover, this had to be achieved at a marginal cost to Sanlian, otherwise the restructuring would be too costly.


Open market purchases of the shares would have been prohibitively expensive.
Table 1. Baiwen’s top six shareholders, 30 December 2000

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Number of shares, m</th>
<th>Stake, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zhengzhou Baiwen Group</td>
<td>28.9</td>
<td>14.6</td>
</tr>
<tr>
<td>Southern Securities</td>
<td>5.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Pengcheng Advertising</td>
<td>4.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Henan Provincial Zhengzhou City Credit Cooperative</td>
<td>2.5</td>
<td>1.3</td>
</tr>
<tr>
<td>Henan Jinxin Computer Information</td>
<td>2.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Zhengzhou People’s Insurance</td>
<td>2.0</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Source: (Zhang 2002), pp. 239-244.

The deal was structured in the following way. Sanlian would purchase Rmb1.45bn ($175m) worth of Baiwen’s debt from Cinda for Rmb300m ($36m), giving the AMC a 21% cash recovery rate on the debt. In exchange, the board proposed that all of Baiwen’s shareholders would be asked to each transfer one half of each of their total stakes in Baiwen to Sanlian for free. Once these transactions were completed, Sanlian would have control of the listed firm and would inject a further Rmb250m ($30m) worth of assets in order to ensure its future growth. For those unwilling to transfer their shares to Sanlian for no charge, Sanlian offered to pay: Rmb1.84 a share for listed shares and Rmb0.18 for non-tradable LP shares. However, if more than 7m of the shares had to be purchased (rather than freely transferred), then the deal would be judged to be too expensive and Sanlian would withdraw. The aim was for the transfers to be completed by June 2001. The plan obviously entailed a cost to the company’s shareholders since they were being asked to diminish their ownership stakes with no guarantee of reimbursement. However, given that a government-financed rescue was not on the table, and that other potential buyers had walked away, the alternative for Baiwen was insolvency, in which case all of Baiwen’s shares would have become worthless. Moreover, the plan entailed some up-side for shareholders if Sanlian was successful. There was some likelihood of this since Sanlian was well-capitalised and successful retailer – one was of Shandong’s eight largest enterprise groups, and so could expect support from the Shandong provincial authorities.

13 Founded in 1985, Sanlian became one of China’s first shareholding companies in 1992. Started initially as an electronics manufacturer, its interests now include real estate, trade, tourism, media and
The restructuring plan was passed at a shareholders’ meeting on February 22\textsuperscript{nd} 2001. However, parts of the bureaucracy were harder to convince. Two applications made by Baiwen’s board for the share transfer to be approved were rebuffed by the Shanghai branch of the Central Settlement and Clearing Company (CSCC) on March 22\textsuperscript{nd} and April 26\textsuperscript{th} 2001. The CSCC argued that Baiwen’s board had no authority to issue ‘compulsory orders’ to shareholders (which is how it saw the 50\% share transfer plan), but could only act on behalf of the shareholders themselves. Although the shareholders meeting had passed the shareholding plan, the CSCC judged that the plan still qualified as a collectively-decided transfer (\textit{jiti}) rather than agreed (\textit{xieyi}) transfer (since a majority of shareholders had passed the decision on behalf of all). Since there were no rules governing such a transaction, the CSCC rejected the application. A subsequent appeal by Baiwen was rejected in June.

A second setback occurred in October 2001 when eight shareholders took Baiwen to the Zhengzhou Intermediate People’s Court. They argued that the ballot used to pass the restructuring plan at the shareholders’ meeting was illegal, their case being based on vague wording in the Company Law. Article 143 of the law affirms the right of shareholders to transfer their shares, and article 39 states that two-thirds of a company’s shareholders must agree on any ‘increase or decrease of registered capital, division, merger, dissolution or change of corporate form of the company’. The law does not specify, however, how such an agreement should be sought.\textsuperscript{14} A secret ballot was used to pass the restructuring plan, while the eight litigants claimed that an open ballot, (a method commonly used in more mundane decisions relating to a company’s operations), was the more appropriate method. On November 9\textsuperscript{th} 2001, the Zhengzhou Court ruled that Baiwen’s restructuring plan had been passed in a legitimate fashion. Given that the court was ultimately governed of the city’s party committee, the decision may well have been politically influenced.

\textsuperscript{14} ‘Zhengbaiwen (600898): Chongzu qu de jinzhang’, \textit{Homeway News}, November 9\textsuperscript{th}, 2001, sourced from \url{http://news.homeway.com.cn}.
Baiwen’s board made a fourth application to the CSCC after the court’s decision. A month earlier, on October 12th 2001, the MoF had approved the transfer of 14.4m state shares held by Zhengzhou Baiwen Group, accounting for 50% of the company’s state shares, to a separate account set up by Baiwen specifically for the restructuring at no charge. This transfer was effected on December 31st 2001. It is not clear what changed the CSCC’s position, though the MoF decision to facilitate state share side of the deal perhaps indicated senior level approval, but on June 25th 2002 the CSCC finally agreed to the share transfer. The next phase of the transfer was completed when 83.9m individual shares held by some 67,610 shareholders were voluntarily transferred. The shares were also placed into Sanlian’s special restructuring account. The CSRC soon after announced that Sanlian was to be exempted from having to make a tender offer. After this had been effected, Sanlian’s total stake in Baiwen amounted to 98.4m shares, a 49.8% stake in the firm. On February 4th 2002 Baiwen’s entire board resigned and Sanlian’s nominees took over the key posts.

*The Baiwen deal aftermath*

The stricter regulatory environment constrained the manoeuvre of Baiwen’s new board. In November 2001 the company made a Rmb940m ($114m) sale of assets to its parent company, the Zhengzhou Baiwen Group. This generated Rmb38m ($4.6m) worth of income, which Baiwen recorded as additional income (*yingye wai shouru*), allowing it to report profits in early 2002. Soon after this Baiwen applied to the SHGSE to be re-listed on the main board. However, the MoF had issued a set of rules concerning accounting methods for related-party transactions on December 21st 2001. According to these rules, this income could not be included as normal income and so in April 2002 the firm was forced to correct its annual report to show a loss of Rmb24m ($2.9m) for 2001, a per share loss of Rmb0.17. As a result, Baiwen’s application for a re-listing was redundant and the dividend planned for spring 2002 was scrapped. The promise to pay a dividend by the end of 2002 also came to naught since the same MoF rules prevented Baiwen from using the assets from Sanlian to pay dividends.

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15 A requirement for new owners who purchase more than 30% of the listed company. However, up until June 2003, the CSRC granted exemptions to making a tender offer to other shareholders since this would have increased the expense of the take-over and discouraged such rescue deals.
17 ‘Temporary regulations on accounting methods for related-party asset sales’, issued December 21st, 2001 by the MoF.
Off company deficits or to issue a dividend. On April 9th 2002 Baiwen applied to the SHGSE for an extension of its PT status – continued losses meant that it was threatened with a full de-listing thanks to new rules issued by the CSRC in early 2002. After an anxious wait, on April 30th the SHGSE granted the extension. One of the likely reasons for the extension was that the restructuring plan had been delayed for some ten months by the shareholders’ court action – between the suit’s filing in February 2001 and the court’s judgement in November 2001 – Baiwen was unable to implement the plan. On August 16th 2002, Baiwen released its mid-term report for 2002: profits of Rmb11.7m ($1.4m) and per share net income of Rmb0.059. Relisting now appeared to be just a matter of time.

The Baiwen model?

The share transfer plan enabled Sanlian to gain a controlling stake in Baiwen extremely cheaply. Without this innovation, the restructuring could not have succeeded. The deal thus appeared to set a precedent for poorly-performing listed companies wishing to restructure but having difficulties in attracting an external investor and/or concentrating dispersed shareholdings. The Baiwen deal has since inspired a few mimics, especially since the CSRC moved to improve the incentives for shareholders becoming involved in corporate restructurings. However, by November 2003 it was clear that the method was not as useful as had been originally hoped for.

The ‘Third Board’ was established in 2001 by the CSRC, Shenzhen Stock Exchange (SHZSE) and the China Securities Industry Association to provide an over-the-

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18 In an additional bid to polish its accounts, Baiwen disregarded the bad debt reserve levels set at the June shareholders’ meeting. These levels were important since they were an important way of insuring shareholders against the risk that the restructuring failed. For example, the board announced that for receivables expected to be paid within one year’s time, a sum worth 10% of the receivable would be held in case the debtor defaulted. However, the Baiwen board decided that no bad debt reserves were required for receivables expected from related parties, as they carried such a low risk of non-payment. A level of 6% was eventually agreed by the board for such receivables. This decision appears to have been made without consulting the company’s shareholders. Baiwen’s auditor Shandong Tiandanxin however found that in 2001 no reserves were held for Rmb123m ($14.8m) worth of related-party receivables generated on November 30th that year. In 2002, a sum equal to 6% of the outstanding amount (Rmb7.4m ($890,000)) was set as reserves.

19 In western markets, it is often possible for a company to issue new shares to a rescuer as a cheap means of transferring control to them. However, PT status prevents firms from issuing new shares so the free share-transfer is one of the only viable alternatives.
counter (OTC) market for the shares of companies that had been de-listed from the main boards (mostly after a relegation to the PT category and a subsequent failure to successfully restructure and improve performance). By September 2003, the third board hosted some 25 companies. In September 2002 the CSRC announced rules which allowed companies trading here to have all of their non-tradable LP and state shares converted into tradable shares if the firm had been successfully restructured. This was a strong incentive for LP shareholders to organise a restructuring since if it was successful (measured in whether the NAV of the firm went positive), they could sell their shares freely into the open market. Individual shares tend to be traded on the exchanges at a substantial premium to LP shares transferred via off-exchange deals.

Shenzhen Zhonghao Group revealed a restructuring plan on January 15th 2003 that would have made it the first beneficiary of these regulations. The group had been delisted on March 22nd 2001 with Rmb1.2bn ($145m) in debt, accumulated over four years of large losses. According to Zhonghao’s restructuring plan, 50% of its LP shares would be transferred by various shareholders at no cost to Shenzhen City Hengye Industries, a company established by Zhonghao to handle the restructuring. Hengye would then be responsible for paying off Zhonghao’s debt. Hainan Huixuan, the Zhonghao Group’s controlling shareholder, committed to provide Rmb14.3m ($1.7m) in cash to support the debt pay off and, if the restructuring was successful, to inject a further Rmb156m ($18.8m) worth of assets into the company.

These measures were expected to move Zhonghao’s per share net asset value (NAV) from –Rmb7.71 in January 2003 into positive territory. Zhonghao would then qualify under CSRC rules for its non-tradable shares to be converted into tradable shares. By April 2003, Zhonghao’s LP shareholders had agreed to transfer 22m LP shares to

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20 Of which about 12 had been delisted from the main boards, the rest being transferred from the old STAQS market for LP shares.  
Hengye, some 72% of the 30.6m LP shares requested. However, the plan has not been easily implemented. By June 2003, creditors of the company which were owed Rmb115m ($14m) had agreed to the debt restructuring plan, while those banks, asset management companies and trust and investment companies which were owed a total of Rmb522m ($6.9m) had not agreed.

In addition, a small number of LP shareholders had agreed to the transfer plan – owners of 63% of the LP shares that were slated for free transfer were still considering their options by the end of May 2003. A number of shareholders (representing some 4.3m shares, had objected to the restructuring plan at a shareholders meeting, leaving a question over how to deal with them: would a compulsory transfer, as in the Baiwen case, be possible? The fact that the company faced an uphill struggle to re-list also made analysts sceptical about the possibility of a successful restructuring.

Yinshan Chemicals Group, a company based in Sichuan province, was de-listed on August 21st 2002 and has also moved to mimic Baiwen. On January 24th 2003 it announced a restructuring plan with Chengdu Guomao Industries, a trading group also based in Sichuan, based on what was now known as the ‘Baiwen’ model. Guomao was interested in gaining a listing vehicle but did not want to expend any money on the highly-indebted Yinshan. The proposed deal was able to work on the basis of a

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24 However some LP shareholders protested about the announcement on April 1st, 2003 that the controlling shareholder Hainan Huixuan was no longer required to transfer 50% of its LP shares, on the basis that it has already contributed Rmb20m ($2.4m) to the company’s daily expenses and workers’ welfare payments, and will contribute Rmb173m ($20.8m) directly towards the company's restructuring. This transfers much of the risk incurred to the minority shareholders. See Di Jiyong, ‘PT Shenzhenhao: Chongzu you you xin qingkuang, dagudong wuxu churang 50% farengu’, Shenzhen Tequ Bao, April 2nd 2003, sourced from http://news.homeway.com.cn.


share swap. Yinshan’s shareholders offered to exchange their tradable shares on a one-for-one basis with LP shares in Guomao held by the shareholders of Guomao. Following this exchange, according to the plan 50% of the shares held by Yinshan’s shareholders (a mixture of Yinshan’s tradable shares and Guomao’s LP shares) would be transferred to Guomao for no charge. The Yinshan and Guomao boards agreed that this was fair given that on January 24th 2003 Guomao’s per share NAV was Rmb2.1, compared to Yinshan’s per share NAV of –Rmb7.7.28

The transaction would result in two hybrid companies. Yinshan will be comprised of state shares, LP shares (including all of Guomao’s LP shares), and very few tradable shares and would no longer qualify as a list-able company. Guomao would be comprised of state shares and tradable shares (including most of Yinshan’s tradable shares) – and would therefore qualify as a list-able enterprise. As the receiving end of 50% or more of a de-listed company’s shares, it would qualify for a listing and, based on the CSRC’s new rules, potentially also for all of its shares to be made tradable. Original holders of Yinshan’s tradable shares would effectively become holders of Guomao’s shares, although they would posses only half of their original shareholdings. However, Yinshan’s LP shareholders would be forced to lose any immediate chance of re-listing. Moreover, there were worries of state asset losses since the restructured (and unlisted) Yinshan would be unable to repay its debts, worth some Rmb630m ($76m), owed mainly to state-owned banks, while all the benefits of the deal would accrue to the privately-owned Guomao.29

A number of questions reside over the fairness and efficiency of the Baiwen ‘model’. First, the Baiwen deal relied on extensive administrative protection of the listed firm: it was given an enormous amount of time to restructure, the courts were, it appears, instructed to facilitate the restructuring plan (over the objections of some shareholders and legal worries), as were local administrative organs, and the SHGSE gave it an

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28 There were a number of important differences with the Baiwen deal. It was subject to approval of a majority of A-shareholders (rather than all shareholders as in the Baiwen case), and while Baiwen’s shareholders were asked to transfer their shares as a result of a court judgement, Yinshan’s restructuring has not so far depended on a court judgement. See Liu Shui, ‘Yinshan Huagong Chongzu Meiyou Fanban Zhengbaiwen, Shuili Chongzu Youli Liutonggu Gudong’ Shanghai Zhengquanbao, October 21st 2003, sourced from http://cfi.net.cn/id/newspage.asp?200310210071 October 2003.
extension to re-list after the take-over failed to deliver the expected improvement in performance. To effect the deal Sanlian was offered almost a guaranteed return: it spent limited cash gaining control of Baiwen but had huge upside on the deal. According to Meng Qinguo, as long as Baiwen’s A-shares remain trading at above Rmb5 then Sanlian will profit from selling them off over the three years. Overall, the rescue was organised on an administrative basis, sending entirely the wrong signal to shareholders of other listed firms: listed former SOEs will not be allowed to go bankrupt. No listed firms have yet been bankrupted in reform China. ST, PT and now the third board allow failing firms innumerable opportunities to become profitable by hook or by crook. In economic terms, this is clearly a waste of resources. Politically, the rescue deal could be defended on the basis of preventing protests from workers who would have been left without jobs in the event of a bankruptcy. However, other analysts suspected that it was really certain of Baiwen’s shareholders, including local government officials, who were being protected by the rescue deal.

**Fighting for control of Lizhu**

Hostile take-overs on China’s stock market are extremely rare. Since the typical float is so small and government shareholdings are usually concentrated, it is usually impossible to secure control without the explicit agreement of the listed firm’s controlling shareholder (and therefore ultimately its government-owner). However, as the battle for control of Lizhu shows, the contours of a more competitive market in control rights of listed firms are becoming more visible.

On January 16th 2002, China Guangda (Everbright) Group announced its intention to sell its 38.9m LP shares, a controlling 12.7% stake, in Lizhu Group. Guangda, a financial conglomerate operating directly under the State Council, had spent the 1990s investing in numerous non-financial businesses, making large losses. In 2001, the State Council ordered it to rationalise its operations and sell off all its non-financial businesses. Guangda’s announcement triggered a fight for control of Lizhu.

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31 In addition, during 1997-01, Guangda (who only nominated one board member, the Lizhu chairman) had had a number of disagreements about the running of the firm with Lizhu’s top management.
Lizhu, a pharmaceuticals group founded in 1985 in Zhuhai, Guangdong province, was listed on the SHZSE in 1993.33 Lizhu was an attractive acquisition for a pharmaceuticals firm. The firm was successfully involved in both drug production and sales, its portfolio consisting of more than 300 products, over-the-counter and prescription drugs. More importantly, however, for Taitai, Lizhu controlled a well-established network of some 2,000 sales representatives at prescription outlets across China, a precious resource since some 80% of medicine sales in China occur at prescription outlets within hospitals.34 Lizhu had built up its network of sales people over some ten years, developing strong relationships with doctors and hospital directors. A new entrant to China’s drugs market could easily establish a network of over-the-counter stores, but breaking into this prescription side of the business is much harder.

In the first six months of 2002, Lizhu’s main business income totalled Rmb717m ($86.4m), profits from its main business totalled Rmb324m ($39.0m) and its net profits were Rmb42.4m ($5.1m), increases of 10.9%, 7.7% and 33.6% respectively on the same period in 2001.35 Its financial results are shown in Table 2.

Table 2. Lizhu before, during and after the acquisition deal

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from main business, Rmb m</td>
<td>1,396</td>
<td>716.7</td>
<td>1,137</td>
</tr>
<tr>
<td>Profits from main business, Rmb m</td>
<td>651.2</td>
<td>323.7</td>
<td>505.9</td>
</tr>
<tr>
<td>Total profit, Rmb m</td>
<td>101.9</td>
<td>64.6</td>
<td>107.0</td>
</tr>
<tr>
<td>Net profit, Rmb m</td>
<td>50.4</td>
<td>42.4</td>
<td>68.7</td>
</tr>
<tr>
<td>Total assets, Rmb m</td>
<td>1,676</td>
<td>1,926</td>
<td>1,964</td>
</tr>
<tr>
<td>Liability-asset ratio, %</td>
<td>38.1</td>
<td>41.6</td>
<td>40.7</td>
</tr>
<tr>
<td>Per share net asset value, NAV</td>
<td>3.0</td>
<td>3.15</td>
<td>3.23</td>
</tr>
<tr>
<td>Per share income, Rmb</td>
<td>0.16</td>
<td>0.14</td>
<td>0.22</td>
</tr>
<tr>
<td>Return on net assets, %</td>
<td>5.5</td>
<td>4.4</td>
<td>7.0</td>
</tr>
</tbody>
</table>


32 A brief account of the Lizhu case can be found in Xin ‘Mingying Ziben Qibing’, Xin Caifu Zazhi, August 2002, pp. 77-79.
Lizhu’s share structure did not appear to facilitate an easy take-over, however, since its shares were dispersed among a large number of shareholders. Before restructuring into a shareholding company and listing Lizhu was a collective (jiti qiye) rather than an SOE. Table 3 shows its top ten shareholders at the end of 2001. The controlling stake, owned by Guangda, only amounted to 12.7%, the top ten shareholders held less than 30% of the company, and a high proportion of Lizhu’s shares (77.8%) were listed and tradable. Given this, any buyer would have to secure both Guangda’s LP shares and a considerable proportion of other shares, some perhaps from the open market, if control was to be assured. This would be an expensive proposition if word of the acquisition bid spread and shareholders and investors bidded up the share price accordingly. In contrast, most of the take-overs organised in China’s stock market in the last few years have involved the relatively cheap transfer of a single LP share stake, large enough in itself to endow control.

Table 3. Lizhu’s top ten shareholders, 31 December 2001

<table>
<thead>
<tr>
<th>Rank</th>
<th>Shareholder name</th>
<th>Number of shares held</th>
<th>Percentage stake, %</th>
<th>Share type</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>China Guangda Group</td>
<td>38,917,518</td>
<td>12.72</td>
<td>LP shares</td>
</tr>
<tr>
<td>2</td>
<td>Zhuhai City ZLIC Investment Co.</td>
<td>22,379,239</td>
<td>7.31</td>
<td>LP shares</td>
</tr>
<tr>
<td>3</td>
<td>China Guangtai Pharmecueticals</td>
<td>15,628,395</td>
<td>5.11</td>
<td>B-shares</td>
</tr>
<tr>
<td>4</td>
<td>Guangzhou City Baokeli Trading</td>
<td>6,059,428</td>
<td>1.98</td>
<td>LP shares</td>
</tr>
<tr>
<td>5</td>
<td>Jinsheng Securities Investment Fund</td>
<td>2,671,039</td>
<td>0.87</td>
<td>A-shares</td>
</tr>
<tr>
<td>6</td>
<td>Shanghai Securities</td>
<td>1,561,793</td>
<td>0.51</td>
<td>A-shares</td>
</tr>
<tr>
<td>7</td>
<td>Tianhua Securities Investment Fund</td>
<td>1,150,000</td>
<td>0.38</td>
<td>A-shares</td>
</tr>
<tr>
<td>8</td>
<td>Jingyang Securities Investment Fund</td>
<td>1,144,252</td>
<td>0.37</td>
<td>A-shares</td>
</tr>
<tr>
<td>9</td>
<td>Han Guiyi (an individual)</td>
<td>1,017,464</td>
<td>0.33</td>
<td>A-shares</td>
</tr>
<tr>
<td>10</td>
<td>Xibu Securities</td>
<td>899,232</td>
<td>0.29</td>
<td>A-shares</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>91,428,360</td>
<td>29.87</td>
<td></td>
</tr>
</tbody>
</table>

Source: [www.tsing.com](http://www.tsing.com)

An attempted employee buy-out

Guangda initially acquired its stake in Lizhu in 1998 from Macao Nanyue and the Zhuhai Guihua Workers’ Co-operative (ZGWC). ZGWC was formed by Lizhu employees in 1992. Guangda sold its stake on January 4th 2001 to Zhejiang International Trust and Investment Company (ZITIC). This was an attempt at an
indirect management buy-out since once this deal had been completed, ZITIC entrusted the 12.7% stake to ZGWC. The co-operative paid Rmb3.16 a share for trust (weituo) of the shares, an arrangement which gave them de facto control but not ownership rights.\textsuperscript{36}

Guangda did not sell directly to the workers’ co-operative since a 1995 ruling restricted ‘collective legal persons’, such as the workers’ co-operatives, from engaging in business activities.\textsuperscript{37} The ZGWC was thus unable legally to own Lizhu’s own shares. The ploy, however, was unsuccessful. On March 2\textsuperscript{nd} 2001 the ZITIC/ZGWC deal was annulled by the MoF and the LP share stake reverted to Guangda’s control. The other problem with the deal was that, allegedly, management had been involved in massaging the firm’s accounts in order to make it appear Lizhu was less valuable than it really was. They wrote off some Rmb200m ($24m) in receivables, an act which reduced the net asset value of the company. This in turn lowered the price that Lizhu management had to pay to buy out the firm. The authorities were apparently aware of the scam, and this was probably another factor in the deal’s failure to gain the MoF’s approval.

The workers’ co-operative was not deterred however. It restructured itself, re-registered as Zhuhai Investment Company (ZLIC), and then spent Rmb2.0 per share to purchase 22.4m of Lizhu’s LP shares, this time from the Guangzhou Pharmaceuticals and Health Supplements Import & Export Company and Zhuhai City Pharmaceutical. With a 7.31% stake, ZLIC – representing the employees – became Lizhu’s second largest shareholder.

Harbin’s Hayao Pharmaceuticals Group and Xian’s Dongsheng Group expressed an interest in buying Lizhu from Guangda. However, Hayao withdrew from talks in February 2002 and the contest was apparently thus left to ZLIC and Dongsheng, until March 27\textsuperscript{th} 2002 when ZLIC announced it had sold its 7.31% stake to Taitai Pharmaceutical, a privately-owned Shenzhen-based firm. Taitai paid Rmb4.1 per

share, almost double the amount ZLIC had spent itself and 38% more than the shares’ NAV of Rmb2.97.\(^{38}\)

**Taitai Pharmaceutical**

Taitai began life in December 1992 as Shenzhen Emier Food Company, and in 1993 began selling Taitai Beauty Essence (*Taitai Koufuye*), an oral product which quickly became one of China’s best-selling beauty products.\(^{39}\) Zhu Baoguo had purchased the infusion’s formula in 1992 for Rmb90,000 ($18,000) and then in 1993 bought out the two original shareholders with a loan from a Wenzhou-based financier.\(^{40}\) In June 1995, the company changed its trading name to Shenzhen Taitai Pharmaceuticals. Taitai listed 70m A-shares on the SHGSE on June 8\(^{41}\) 2001 after raising Rmb24.8 a share, a total of Rmb1.6bn ($192.8m).\(^{41}\)

The challenge for Zhu and the company was two-fold: to diversify both its product range and its sales network. In 1997, Taitai Beauty Essence accounted for some 99% of sales. Six new drugs launched in 2001 only generated Rmb26.0m ($3.1m) worth of sales. In 2001, Taitai Beauty Essence still accounted for 76.3% of sales, some Rmb518m ($62.4m). If it was to become China’s most successful pharmaceuticals company Taitai needed to diversify its product range. Second, it needed to strengthen its distribution network, dependent as it was on the OTC market. Taitai needed to gain access to the prescription market if it was to develop strongly.

The share issue provided Taitai with the funds it would need to pursue an aggressive acquisition-based strategy of expansion.\(^{42}\) In April 2002 the firm acquired Jiankang

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38 Interview, Shenzhen, September 2003.

39 Taitai’s 2003 corporate brochure (p. 24) states that Taitai Beauty Essence ‘contains many active ingredients which can regulate the level of endocrine and stimulate blood flow. It also has liver and kidneys enhancing function, and will aid metabolism and blood circulation’.

40 The loan was from a listed company with capital to spare. Zhu was charged annual interest of around 35% and repaid the capital and interest over a period of only twelve months. Interview, Shenzhen, September 2003; ‘Mingying Ziben Qibing’, *Xin Caifu Zazhi*, August 2002, pp. 77-79.

41 The company could not list on the Shenzhen Stock Exchange since it had stopped listing new enterprises in 2000.

42 Taitai’s board of directors also decided to use some of the capital to pay off Rmb112m ($13.5m) worth of outstanding loans, as well as Rmb30m ($3.6m) of the outstanding loans of one of its subsidiaries, Haibin Pharmaceuticals. The firm then invested Rmb360m ($43.4m) in government bonds. These measures lowered the firm’s debt-equity ratio to 12.7%, which allowed Taitai and its subsidiaries to borrow the capital for further acquisitions at competitive rates. The financial activities
Pharmaceuticals, a producer of drugs and health supplements based in Hong Kong.\textsuperscript{43} This purchase lowered the share of sales in 2002 from the Taitai’s oral infusions to 67.7\%\textsuperscript{44}

The Lizhu deal occurred thus. Taitai’s chairman and sole shareholder, Zhu Baoguo, had approached the management of Lizhu in 1996 with an acquisition offer based on his desire to gain Lizhu’s prescription marketing network. He was rebuffed, reportedly since Lizhu’s state shareholders were not comfortable selling to a private businessman. In 2002, Lizhu’s management went to visit Zhu on their own initiative, offering to sell their stake for Rmb4.1 a share. Zhu agreed immediately.

If ZLIC acquired Lizhu’s shares in order to facilitate an employee buy-out, why did its management now want to sell out to Taitai? The move appears to have been motivated by a desire to prevent a take-over by a buyer disliked by Lizhu management. Since it was unable to sell its shares in Lizhu in 2001, Guangda had been looking for another buyer – and it was now willing to sell indiscriminately to the highest bidder.\textsuperscript{45} ZLIC’s influence over the board was looking tenuous.\textsuperscript{46} In selling to Taitai, a firm that promised not to break up Lizhu, as many feared that Dongsheng would do, ZLIC was protecting its shareholders, the employees of Lizhu.\textsuperscript{47} Lizhu had some 15 subsidiaries around China, and it would have been relatively easy for a buyer to spin these off. Talks with Harbin’s Hayao also failed since Lizhu’s management

\textsuperscript{43} Jiankang, known in English as Health Pharmaceuticals (China), had a thirty year history in Hong Kong and was the owner of the famous ‘Eagle’ brand. Tiancheng, Taitai’s Hong Kong window company, purchased 25\% and Taitai the other 75\% of Jiankang’s share capital at a total cost of HK$130m ($16.8m).
\textsuperscript{44} Taitai Pharmaceutical Annual Report (2001), sourced from \url{http://www.cninfo.com.cn}.
\textsuperscript{45} Guangda also made a renewed effort to gain influence on the board. On March 11\textsuperscript{th} 2002 Guangda nominated three new directors to the board in an effort to exert more influence. A vote on the appointments was scheduled for the April shareholders’ meeting.
\textsuperscript{46} At the time of the deal, the members of Lizhu’s board had not changed since 1993. The company was not performing badly: net profits had doubled from Rmb10.4m ($1.3m) in 2000 to Rmb21.2m ($2.7m) in 2001, return on net assets was 5.48\%, up from 1.13\% the previous year, and debt stood at 38.1\% of assets at year-end 2001. But despite this, the shareholders had only received dividends twice since 1997. Some were also annoyed at Lizhu’s management’s attempts to manipulate the accounts. Given this poor performance, it was possible that other shareholders were willing to sell their shares to a buyer who would attempt to break up the company.
\textsuperscript{47} Interview, Shenzhen, September 2003.
were concerned that selling to an SOE like Hayao risked them being sold on to another buyer in the near future.

With its 7.1% stake in hand, Taitai moved aggressively to increase its holding. It approached Guangda to buy its stake, but was rebuffed. Undeterred, it sought another route. In March 29th 2002, Shenzhen’s Haibin Pharmaceuticals, which Taitai controlled, acquired 683,700 of Lizhu’s listed A-shares, increasing Taitai’s aggregate stake to 7.54%. Between April 3rd and 5th 2002, Taitai itself purchased 9.37m of Lizhu’s A-shares for around Rmb11 per share, while Taitai’s Hong Kong-based, wholly-owned subsidiary Tiancheng Industries purchased 5.93m B-shares for the equivalent of some Rmb5 per share. When these developments were announced on April 9th 2002, Taitai’s stake stood at 12.5%, just less than Guangda’s 12.7% controlling stake. Taitai had spent some Rmb240m ($29m) on the acquisition so far.

**Dongsheng Group enters the fray**

Meanwhile the Dongsheng Group was preparing its own challenge for control of Lizhu. On April 8th 2002 it registered 54m of its shares in Dongsheng Technology, its listed subsidiary (stock code: 600771, a.k.a. Topsun Science and Technology), with the Shanghai branch of the CSCC in order for them to be mortgaged for a Rmb80m ($9.6m) loan from the Xian Dongdajie branch of the China Construction Bank. The loan required 99.9% of the group’s holding in Dongsheng Technology’s shares. Trading in Lizhu’s shares was then suspended for three days in anticipation of news that would affect the share price. On April 17th 2002, Dongsheng revealed that Guangda had entrusted its entire 12.7% stake in Lizhu to it for Rmb170m ($20.6m). The deal was not structured as a straight sale since Guangda, being a state-owned organ, would have required approval from the MoF before it sold assets to a private

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49 The prices of Taitai’s acquisitions are reported by Han Qiang 2002. Tiancheng, Taitai’s Hong Kong subsidiary, established as a Taitai window company, Zhang Ke & Wu Jingkai, ‘Taitai Yaoye zhizai konggu Lizhu guquan zhengduo jinru bairehua’, Yuegang Xinxi Ribao, April 10th 2002, sourced from http://news.homeway.com.cn
51 Dongsheng paid a higher price per share for trust authority over the shares than Taitai had paid for ownership of ZLIC’s shares, some Rmb0.2 more.
Old Stocks, New Owners: Two Cases of Ownership Change in China’s Stock Market

firm, and Dongsheng’s management feared that this approval process would either
take too long or would be rejected outright.

Dongsheng and Taitai were now openly competing for control of Lizhu. Dongsheng
was a privately-owned enterprise like Taitai, but the two companies had followed
differing growth strategies. Established in May 1995 in Xian, Shaanxi province, as a
beverage producer Dongsheng entered the drugs sector in December 1996 when it
acquired Shaanxi Weidong Pharmaceuticals. This was the first reported private
enterprise acquisition of a SOE in the province. Dongsheng immediately sought a
public listing and eventually achieved a back-door listing in 1999 by buying 28.9% of
Qinghai Aluminium, a listed former-SOE, for Rmb59m ($7.1m).52 Dongsheng’s
subsidiary at the time, Shaanxi Dongsheng Pharmaceutical acquired a further 23.5%
of the listed firm’s shares.

In January 2000 Qinghai Aluminium changed its name to Qinghai Dongsheng
Technology (the ‘Qinghai’ part of the name was later lost) and to complete the
reinvention of the listed shell, Dongsheng swapped the listed firm’s aluminium
production facilities with the pharmaceutical assets of its second largest shareholder,
Dongsheng Pharmaceutical. The listed company consolidated its new business by
acquiring one of China’s only anaesthetics manufacturers, Qinghai Pharmaceuticals,
in August 2000, as well as Jiangsu Qidong Gaitianli Pharmaceuticals in November
later that year.53 Taitai was competing with an experienced and aggressive player.

An unexpected outcome

When Dongsheng became Lizhu’s single largest shareholder in April 2002, analysts
examined Dongsheng and Taitai’s alliances with Lizhu’s other shareholders in order
to predict the outcome of the acquisition battle. ZLIC, the company established by
Lizhu employees, acquired 1.98% of Lizhu’s shares from what was Lizhu’s fourth
largest shareholder, Guangzhou City Baokeli Trading Company on April 10th 2002.

52 For a detailed study of Dongsheng’s activities see Tsui, E. & Green, S., ‘Light and Shadow’, CFO
53 The latter acquisition was particularly profitable. Re-packaged and re-marketed, sales of Gaitianli’s
‘Baijiahei’ increased from Rmb23m ($2.8m) in 2000 to Rmb239m ($28.7m) in 2001, becoming
China’s most popular cold and flu medication. Two other popular products Gaitianli and Weiaoxin
increased their sales by 113% and 30% respectively on 2000. See ‘Lizhu Jituan (000513): Dongsheng
Old Stocks, New Owners: Two Cases of Ownership Change in China’s Stock Market

ZLIC was thought likely to sell these shares to Taitai, in addition to the 7.31% it had sold in March. Taitai’s stake were thus expected to reach 14.6%.\(^{54}\)

However, Dongsheng was thought likely to gain the 5.06% holding of Lizhu’s third largest shareholder, Guangtai Pharmaceuticals, through the latter’s alliance with Guangda. Guangtai and Guangda had had commercial relations in the past. Guangtai had expressed its allegiance to its former partner, although Guangda had no controlling stake in Guangtai.\(^{55}\) If this allegiance held, Dongsheng would remain the controlling shareholder of Lizhu with a 17.8% stake. For Taitai to win control, Guangtai’s stake was crucial.

An announcement from Taitai on April 26\(^{th}\) 2002 reversed analysts’ predictions.\(^{56}\) First, Taitai had continued to purchase Lizhu’s A-shares on the open market. During April 12\(^{th}\) - 22\(^{nd}\) it purchased 510,000 A-shares for between Rmb12.3 and Rmb12.8 per share. Meanwhile, Tiancheng Industries (Taitai’s Hong Kong subsidiary) had increased its 5.93m B-share stake, purchasing an additional 4.8m B-shares. In total the two companies had acquired an additional 1.75% of Lizhu during this period from the secondary market.

Second, the analysts had misread the state of relations between Guangda and Guangtai. Taitai had been in informal negotiations with Guangtai for months – and, crucially, was able to make any payment in cash. This was enough to sideline Dongsheng. According to an agreement between Guangtai and Tiancheng (Taitai’s Hong Kong subsidiary) signed on April 23\(^{rd}\) 2002, on April 25\(^{th}\) Tiancheng purchased Guangtai’s 5.06% stake (15.5m B-shares) for around Rmb6 per share.\(^{57}\) As a result, Taitai became the largest shareholder in Lizhu with a 19.34% stake, 6.14% more than


\(^{57}\) Although the shares were listed on the exchange, it is legal for them to be transferred at the listed price in an agreed transaction.
Dongsheng. For its part Guangda had remained silent and its leadership had taken a passive position in the battle for control.59

On May 9th 2002 Taitai’s lead increased to 8.6% when, as expected, ZLIC transferred its 1.98% stake in Lizhu, taking Taitai’s total stake to 21.32%.60 The price of this latter transaction was not disclosed. The total cost of the acquisition of Lizhu was some Rmb500m ($60m), much more than Taitai’s management had initially planned for. The nine distinct purchases of Lizhu shares by Taitai and its subsidiaries are shown in Table 4. Lizhu’s shareholding structure in June 2002 is shown in Table 5.

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58 B-shares were good value for money because they had the same rights as other tradeable shares, but cost less. Taitai and its subsidiaries purchased Lizhu B-shares for a 50% discount on A-shares.
59 An interview explained this by the fact that Guangda’s top managers were all state-appointees and had no mandate to compete for ownership of a private company, Interview, Shenzhen, September, 2003.
<table>
<thead>
<tr>
<th>Transaction number</th>
<th>Date</th>
<th>Seller</th>
<th>Buyer</th>
<th>Number and type of Lizhu’s shares</th>
<th>Stake in Lizhu, %</th>
<th>Price paid per share, Rmb (approx.)</th>
<th>Total paid, Rmb m (approx.)</th>
<th>Taitai’s (and subsidiaries’) cumulative stake in Lizhu</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>March 27th 2002</td>
<td>ZLIC</td>
<td>Taitai Pharmaceutical</td>
<td>22.4m LP shares</td>
<td>7.3</td>
<td>4.1</td>
<td>91.8</td>
<td>7.3</td>
</tr>
<tr>
<td>2</td>
<td>March 29th 2002</td>
<td>Open market transactions</td>
<td>Haiben Pharmaceutical (controlled by Taitai)</td>
<td>683,700 A-shares</td>
<td>0.2</td>
<td>Unknown</td>
<td>7.5</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>April 3rd-5th 2002</td>
<td>Open market transactions</td>
<td>Taitai Pharmaceutical</td>
<td>9.37m A-shares</td>
<td>3.1</td>
<td>11</td>
<td>103.1</td>
<td>10.6</td>
</tr>
<tr>
<td>4</td>
<td>April 3rd-5th 2002</td>
<td>Open market transactions</td>
<td>Tiancheng Industries (Taitai’s Hong Kong subsidiary)</td>
<td>5.93m B-shares</td>
<td>1.9</td>
<td>5.0</td>
<td>29.9</td>
<td>12.5</td>
</tr>
<tr>
<td>5</td>
<td>April 12th-22nd</td>
<td>Open market transactions</td>
<td>Taitai Pharmaceutical</td>
<td>510,000 A-shares</td>
<td>0.1</td>
<td>Rmb12.3-12.8</td>
<td>6.3</td>
<td>12.6</td>
</tr>
<tr>
<td>6</td>
<td>April 12th-22nd</td>
<td>Open market transactions</td>
<td>Tiancheng Industries</td>
<td>4.8m B-shares</td>
<td>1.6</td>
<td>Unknown</td>
<td>14.2</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>April 25th</td>
<td>Guangtai</td>
<td>Tiancheng Industries</td>
<td>15.5m B-shares</td>
<td>5.1</td>
<td>About Rmb6</td>
<td>93</td>
<td>19.3</td>
</tr>
<tr>
<td>8</td>
<td>May 9th</td>
<td>ZLIC</td>
<td>Taitai Pharmaceutical</td>
<td>6.1m LP shares</td>
<td>2.0</td>
<td>Unknown</td>
<td>21.3</td>
<td></td>
</tr>
</tbody>
</table>

Source: Authors’ research based on assorted media reports cited in footnotes.
Table 5. Lizhu’s top ten shareholders, June 30th 2002

<table>
<thead>
<tr>
<th>Rank</th>
<th>Shareholder</th>
<th>Number of shares held</th>
<th>Percentage stake, %</th>
<th>Share type</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>China Guangda Group (entrusted to Dongsheng)</td>
<td>38,917,518</td>
<td>12.72</td>
<td>LP shares</td>
</tr>
<tr>
<td>2</td>
<td>Shenzhen Taitai Pharmaceuticals</td>
<td>32,260,916</td>
<td>10.54</td>
<td>LP: 22,379,239 A: 9,881,677</td>
</tr>
<tr>
<td>3</td>
<td>Tiancheng Industries (controlled by Taitai)</td>
<td>26,254,595</td>
<td>8.52</td>
<td>B-shares</td>
</tr>
<tr>
<td>4</td>
<td>Shenzhen City Haibin Pharmaceuticals (controlled by Taitai)</td>
<td>6,752,435</td>
<td>2.21</td>
<td>A-shares</td>
</tr>
<tr>
<td>5</td>
<td>Guangzhou City Baokeli Trading</td>
<td>6,059,428</td>
<td>1.98</td>
<td>LP shares</td>
</tr>
<tr>
<td>6</td>
<td>Guoxin Securities</td>
<td>2,957,511</td>
<td>0.97</td>
<td>A-shares</td>
</tr>
<tr>
<td>7</td>
<td>Kexun Securities Investment Fund</td>
<td>2,835,000</td>
<td>0.93</td>
<td>A-shares</td>
</tr>
<tr>
<td>8</td>
<td>Yulong Securities Investment Fund</td>
<td>1,800,161</td>
<td>0.59</td>
<td>A-shares</td>
</tr>
<tr>
<td>9</td>
<td>Huaxia Chengzhang Securities Investment Fund</td>
<td>1,706,782</td>
<td>0.56</td>
<td>A-shares</td>
</tr>
<tr>
<td>10</td>
<td>Natwest Securities Hong Kong</td>
<td>1,344,521</td>
<td>0.44</td>
<td>A-shares</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>120,888,867</td>
<td>39.46</td>
<td></td>
</tr>
</tbody>
</table>

Source: Based on data supplied by www.tsing.com

Dongsheng’s failure to launch an effective counter-attack was rooted in its financial constraints. The group had already become indebted purchasing Guangda’s stake. Half of its bid was raised by mortgaging its shares in Dongsheng Technology (its entire stake save 483 shares). Dongsheng did not benefit from the financial resources of its sometime ally Guangda, is a huge financial conglomerate with assets of more than Rmb700bn ($84bn). In addition, Dongsheng Technology’s acquisition of Gaitianli Pharmaceutical contributed to its cash flow problems. The purchase had cost Dongsheng Rmb12m ($1.5m) in cash. A second problem associated with this deal was that the Qidong county government, Gaitianli’s former owner, reneged on its promise to Dongsheng Technology to collect Gaitianli’s Rmb90m ($10.8m) worth of receivables, or otherwise pay the listed company the outstanding sum in cash by May 2002. It did neither. These funds would have probably been enough to challenge

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Old Stocks, New Owners: Two Cases of Ownership Change in China’s Stock Market

Taitai/Tiancheng’s acquisition of the 5.06% stake from Guangtai in April 2002. However with the Qidong government’s failure to provide the cash, and an apathetic Guangda, Dongsheng appears to have been left without the financial resources it needed to continue the fight.63

Taitai’s position was cemented on June 26th 2002 at Lizhu’s shareholders meeting, when the board accepted seven new directors from Taitai, only two from Dongsheng, and Zhu Baoguo, Taitai’s CEO, as the company’s new chairman.64 True to its promise, Taitai has not restructured Lizhu since the deal, nor changed the management structure.65 Taitai has continued to buy Lizhu shares on the open market, taking its total stake to around 25% by September 2003.66

Concluding remarks

Most of the take-overs organised in China’s stock market in recent years have involved the transfer of a single LP share stake, large enough in itself to endow a change in control. The majority of these deals involved a government LP shareholder on the sale side. They often involve a private firm as the purchaser; most are facilitated by local administrative officials. This was the case in Dongsheng’s take-over, restructuring and re-invention of Qinghai Aluminium in 1999. In the case of Baiwen, a value-destroying listed firm was rescued in much the same way as Qinghai Aluminium, although in the Baiwen case the buyer was another state-controlled company. Market logic would usually mean that a firm such as Baiwen would be delisted and then liquidated. However, political logic – the need to maintain job stability in Zhengzhou – meant that this was not an alternative for local officials.

62 Marketing, advertising and re-packaging Gaitianli’s products and supporting several new product launches increased total revenues by 43% during 2000-01, although net profits fell 23% during the same period.
63 These financial difficulties have apparently continued. In September 2003 its debt ratio was reported to be above 80% and observers noted that it was having to pay interest on its non-controlling stake in Lizhu. In contrast, Taitai had over Rmb1bn ($120m) in cash sitting in the bank and was working on another major acquisition, Interview, September, 2003.
65 However, on January 5th 2003 it was announced that Lizhu’s general manager for 17 years, 67-year old Xu Laoxian, would be replaced by Xiao Siyang. Xu’s successor had experience from previous appointments at the Sino-German pharmaceutical joint venture Bayer China, as well as Tianjin Smith Kline & French Laboratories, a Sino-British joint-venture 55% owned by SmithKline Beecham, a leader in China’s OTC market, and Unilever China. See ‘Taitai Yaoye: Xuan ding Lizhu xin zhang men da zao ‘ju wu ba’ zhongren’, Nanfang Ribao, January 6th 2003, sourced from http://news.homeway.com.cn.
The two cases examined above highlight a number of trends in China’s stock market development. First, there is increased commercial transfer of control of listed companies. Administrative transfers are now rare. Even the Baiwen deal was structured as a commercial transaction and Sanlian entered into the transaction with a commercial motive. Thanks to the (albeit constrained) loosening of constraints on LP share liquidity, ownership change (and the whole set of disciplines this entails for management) is facilitated. This bodes well for the future of listed firms as it raises the chances that assets will end up with productive owners. Further de-concentrations of shareholdings would enhance this market since it would lead to easier take-overs and even battles for control, as in the Lizhu case.

Second, the Baiwen case, in which the buy-out was organised to support a failing state firm, revealed that the local state is still active in supporting the firms it owns. Although it could not rely on direct subsidies, soft bank lending or an administrative transfer of control, it suggests that industrial policy is still active. Cinda AMC’s attempt to bankrupt Baiwen was a positive sign, but the whole machinery of the local courts and administrative bureaux, as well as implicit CSRC support and explicit SHGSE aid, were used to force through an artificial restructuring. The lack of a real threat of delisting still undermines corporate governance on China’s exchanges.

Third, both deals involved relatively complex buy-out strategies, in comparison to the usual one-off transfer of a large LP share block. Both involved the transfer and concentration of both individual and LP shares. The take-over of Lizhu involved the exertion of control over the listed firm via holdings of different categories of shares by different parts of a single group. The Baiwen deal was unorthodox in its delivery of control to a new owner by forcing current shareholders to transfer for free one half of their holdings. This method met some resistance from the courts, but now appears to be accepted as a means of facilitating restructuring deals when shareholdings are dispersed and a buy-out involving purchases of shares on the open market would be prohibitively expensive. By allowing Sanlian to gain control of Baiwen almost for free, incentives for restructuring the firm were created. The Taitai take-over also

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66 Interview, September 2003.
involved a relatively sophisticated take-over strategy, involving the co-ordination of purchases via the open market and through one-to-one agreements, as well as the use of subsidiaries to accumulate shares. The exertion of control over listed firms via holdings of shares by a number of related firms is becoming more common – and as a result the question of who ultimately controls listed firms is becoming more difficult to answer. As a result of the Lizhu take-over, the proportion of shares held by the top ten shareholders rose from just under 30% in December 2001 to 40% in June 2002. A similar pattern is seen in the holdings of the top three shareholders – their proportion holding increased from 25.1% to 31.8% over the same period.

Fourth, both buyers signalled a commitment to their new acquisition. Corporate restructurings of listed companies in China have frequently fallen victim to manipulation by short-term buyers. The classic scam involved a ‘white knight’ rescuer announces an attractive-sounding restructuring plan, this triggers a jump in the share price, this allows the rescuer to sell his own shares, and the restructuring plan is soon forgotten. The classic example of such a scam was the Zhongke Chuangye scandal.67 In contrast, Sanlian announced a plan that signalled its long-term commitment in Baiwen. It pledged not to sell its holdings of Baiwen’s state shares, accounting for 22.9% of the total share capital, until at least three years after the acquisition. In addition, it pledged that its holdings of Baiwen’s individual shares, accounting for 27.1% of the total, would be held for at least a year after June 27th 2002. The shares would then be sold, one third at a time, at 12, 24 and 36 month intervals.68 In the case of Taitai, the cost of the deal, some Rmb500m ($60.2m) was enough to signal to investors its long-term commitment to Lizhu.

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References


