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The Privatization two-step at China’s listed firm

by

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Introduction

During the 1990s, China’s stock market was subordinated to industrial policy and as a result it did not facilitate the privatisation of listed firms. Instead, it supplied capital to those state-owned enterprises (SOEs) that restructured into shareholding companies and listed. Some 1,200 ‘one-third privatised’ state firms received approximately Rmb1,042.6bn ($125.6bn) in investment capital via initial, rights and secondary share issues up to April 2004, an average of Rmb869m ($104.7m) each. Incorporation and a listing was designed to improve firm performance while allowing the state to retain control. This strategy is now widely perceived to have failed. The performance of the majority of listed companies has declined after their restructuring and listing, mostly due to the flawed governance structures and inadequate performance incentives caused by continued state ownership. Asset insertions and debt forgiveness, which have taken place on a large scale since 1997, have not much helped. This failure, combined with increased regulatory scrutiny by the China Securities Regulatory Commission (CSRC), has altered the incentives facing legal person (LP) shareholders, the state-affiliated owners of one-third of the equity capital of the average listed company. No longer can these shareholders so easily profit by manipulating the share price of, and stripping assets from, their listed firms. As a result, they are deciding, in ever-greater numbers, to sell their LP shares, mostly to private investors seeking backdoor listings. Crucially, control rights over the firms involved often change as a result of these transactions. By the end of 2002 some 590 listed companies had experienced a change in control, resulting in a total of some 200-250 privately-controlled listed firms.

Two-step privatisation – first a sale of a minority stake and a listing, then an off-exchange transfer of control – has enormous implications, not only for China’s stock market, but also for the country’s industrial and financial sectors. First, two-thirds privatisation should result in firm-level efficiency gains. All else being equal, private control should result in improved firm performance as profit motives are introduced, budget constraints are hardened and administrative interference in firm operations are reduced. The demonstration effects of successful privatisation on the stock exchanges would be important for encouraging ownership transfer elsewhere in industry. Second, these sales allow greater numbers of private firms to gain access to stock market finance through backdoor listings. This is a positive trend since it allows the most dynamic part of China’s economy access to a valuable source of investment capital – and investors access to successful companies. Third, together with the liberalisation of investment rules set in motion by concessions made to join the

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1 For introductions to China’s stock market see Green (2003) and Green (2004).
2 This calculation is based on the author’s estimate that 100 of the 1,300 firms listed by April 2004 were not originally SOEs but collectives, foreign-invested firms or private enterprises, and were therefore excluded from the calculation.
3 These numbers include private firms listed in their own right.
World Trade Organisation (WTO), the LP share market should facilitate greater foreign direct investment (FDI) into China’s listed companies.

This paper is divided into three parts. The first reviews the history of China’s non-tradable shares and outlines the problems that result from continued state control. The second provides a detailed description of the sale process, the regulatory framework and analysis of the motivations of buyers and sellers of non-tradable equities. The final part assesses ‘two-step privatisation’ as a method of corporate restructuring, outlines some ideas to improve it, and then turns to the vexing question of how to make state and LP shares tradable, an issue of much importance within policy circles at present.

The problem with non-tradable shares

At the third plenum of the fourteenth congress in November 1993, the Communist Party approved the creation of a ‘modern enterprise system’. The modern corporation limited by shares was at its heart. However, rules were laid down on which SOEs could convert into shareholding companies, and a quota was established for annual public share issuance under the control of the then State Planning Commission. In addition, distinct categories of shares were created and limits on the amount of share capital a restructured SOE could sell to the public were instituted.

In May 1992, two notices established the first national standards for China’s share market and created the categories of individual, legal person (LP) and state shares. Every time an SOE restructures into a shareholding company and (after it has re-registered with its local Industrial and Commercial Bureau and been accepted by the CSRC) lists, it issues three types of share. Individual shares (geren gu) are sold to the public and are the only sort of share that can be listed on the stock exchanges and openly traded. Local government bureaux receive another third of a listed firm’s equity capital, although they hold these shares on behalf of the ultimate owner, the state, and do not generally contribute funds. These state shares (guojia gu) are instead created (at least in theory) to reflect the previous injection of state-owned assets into the entity by these government organs during its previous operations. After its

4 Privatisation generally results in improvements to firm performance. See, for instance, Megginson, Robert et al. (1994); D’Souza and Megginson (1999); and Boubakri and Cosset (1998).
6 ‘The Measures on the Shareholding System Experiment’ jointly issued by the State Commission of Restructuring the Economic System (SCORES), the State Planning Committee (SPC), the Ministry of Finance (MoF), the PBoC and the State Production Office. The SCORES also issued a document entitled ‘Suggestions on Standardising Companies Limited by Shares’, Chen (1997: 433–50).
7 Individual shares are in turn sub-divided into A-shares (traded domestically by domestic individuals and institutions), B-shares (denominated in hard currency, traded domestically by foreign individuals and institutions and domestic individuals), H-shares (HK$-denominated
creation in March 2003, the SASAC assumed ownership of the state shares of central-government level firms, while provincial SASAC have taken control of the state shares of provincial-level firms and manage them under the supervision of the central SASAC. LP shares (faren gu), in contrast, are issued to LP entities, both state and non-state, in return for the injection of assets under their control. The LP shareholder and the listed firm will often have been one and the same firm previous to the restructuring and listing. LP shares can not be listed on the exchanges. Figure 1 shows the incorporation and listing process.

**Figure 1. Restructuring a typical SOE into a shareholding firm**

Note: The ultimate shareholder of a restructuring SOE is usually a local (provincial) rather than central government organ. There are some 150,000 non-incorporated SOEs still in operation, all but 17,000 of them run by local governments.

How many listed firms does the state control? Since the public/private identity of the ultimate owner can not be discerned through share types, Guy Liu and Sun Pei examined each firm, tracing back up the pyramid of shareholders to the ultimate controlling entity. Their results are shown in Table 1. The number of firms ultimately owned by the state was 927, 81.6% of public companies in 2001. Of these firms, the average total voting rights of the state was 47.9%. In contrast, there were only 209 firms under private ownership, and the private entity's shareholdings was an average of 45.7% at the end of 2001.

shares traded freely in Hong Kong), and N-shares (traded in New York, London and Singapore).

8 If they are taken on by state entities, LP shares will often be additionally classified as 'state LP shares', indicating their current ownership status rather than their intrinsic nature. As with all state assets, any state entity wishing to sell such shares must seek permission. If the sale is to a non-state entity, the shares will be re-classified as LP shares.

9 Normally, share issue privatisations around the world involve the government selling a stake in its firm and receiving the revenues. In contrast, PRC firms make offerings and take their own revenues. This problem is discussed below.
Table 1. The ownership of China’s listed firms, year end 2001

<table>
<thead>
<tr>
<th></th>
<th>Proportion of total number of listed firms, % (number of firms)</th>
<th>Shares owned by the largest shareholder (standard deviation)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The state as the ultimate owner</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct control: Government bureaux</td>
<td>9.0% (102)</td>
<td>38.1% (16.5)</td>
</tr>
<tr>
<td>Indirect control: State-controlled institutions (SCIs)</td>
<td>72.6% (825)</td>
<td>49.1% (16.7)</td>
</tr>
<tr>
<td>Breakdown of SCIs: State-controlled publicly listed firms</td>
<td>2.6% (30)</td>
<td>52.9% (19.2)</td>
</tr>
<tr>
<td>State-owned enterprises (SOEs)</td>
<td>58.9% (668)</td>
<td>49.4% (16.5)</td>
</tr>
<tr>
<td>State-controlled unlisted firms</td>
<td>10.0% (114)</td>
<td>46.6% (17.2)</td>
</tr>
<tr>
<td>State-owned academic institutions</td>
<td>1.1% (13)</td>
<td>43.7% (14.7)</td>
</tr>
<tr>
<td>Total state-controlled firms</td>
<td>81.6% (927)</td>
<td>47.9% (17.0)</td>
</tr>
<tr>
<td><strong>Non-state firms and private individuals as ultimate owners</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-state-controlled publicly listed firms</td>
<td>0.2% (2)</td>
<td>19.1% (10.4)</td>
</tr>
<tr>
<td>Unlisted collective firms &amp; TVEs</td>
<td>4.8% (55)</td>
<td>41.5% (17.9)</td>
</tr>
<tr>
<td>Unlisted domestic private firms</td>
<td>12.7% (144)</td>
<td>33.9% (13.8)</td>
</tr>
<tr>
<td>Unlisted foreign private firms</td>
<td>0.7% (8)</td>
<td>36.8% (17.5)</td>
</tr>
<tr>
<td>Total non-state controlled listed firms</td>
<td>18.4% (209)</td>
<td>35.9% (15.4)</td>
</tr>
<tr>
<td>Total of firms in the survey</td>
<td>100.0% (1,136)</td>
<td>45.7% (17.4)</td>
</tr>
</tbody>
</table>

Note: The figures in brackets beside the percentage of shares owned by the largest shareholder are standard deviations of the largest shareholdings.


The creation of different share categories has led to a number of problems. Despite official claims to the contrary, and the fact that these classes of share all enjoy equal voting rights, different shareholders have been endowed with different rights. Individual owners of A-shares, for instance, are discriminated against in terms of pricing: they pay more for their shares than LP shareholders, who are allocated their shareholdings prior to the initial public offering (IPO) at prices close to net asset value (NAV). Moreover, the combination of distinct share categories and continued state control damages corporate governance and performance incentives at listed firms. While the ultimate owner of most listed firms is ‘the state’, state-controlled legal persons are mandated to control the listed enterprise on the state’s behalf – and they usually abuse their control rights thanks to the lack of effective constraints on their powers. Listed firms suffer asset stripping, make false disclosures and become involved in price manipulation scams as a result.

The majority of research suggests that, as a result, firm performance declines after a listing in China — opposite to what happens in most other countries. Chen Gongmeng finds that

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10 Of course, many large firms in developed economies have their shareholdings similarly concentrated. In a study of corporations in 27 developed economies Rafael La Porta et al. found large companies to be typically controlled by families or the state, with controlling shareholders (controlling more than 10 – 20% of the firm’s voting rights) typically enjoying power in excess of their cash flow rights, primarily through the use of pyramids and
performance generally deteriorates both in terms of profitability and efficiency after a listing, as do Wang Xiaozu et al.\textsuperscript{11} Chen and Shih show return on equity (ROE) and earnings per shares (EPS) generally declining at listed firms during the 1990s, the exceptions being firms in the public utilities, transport and financial sectors, all sunrise industries. None of the normal factors seems to impact positively on performance. According to Michael Firth, a change in senior management at or after listing does not lead to an improvement in performance.\textsuperscript{12} Samuel Huang and Frank Song show that even a listing in Hong Kong fails to impact positively on firm performance.\textsuperscript{13} Joseph Aharony et al. also find that firms’ return on assets (ROA) tends to deteriorate after listing B- or H-shares.\textsuperscript{14}

\textbf{The LP share market and two-thirds privatisation}

Until January 1996, there were only 12 reported cases of the controlling shareholder of a listed firm changing through the transfer of non-tradable shares. In contrast, from 1996 to year end 2002, there were 590 cases of listed firms experiencing such a change.\textsuperscript{15} In 2002 alone 168 companies, 14% of the total listed, announced a change in control. During the first three quarters of 2003, 128 companies underwent such changes. These shares remain non-tradable on the stock exchanges.

These deals include transfers of both LP and state shares. Until August 2002, all for-cash commercial transactions (as opposed to administrative transfers, on which more below) involved LP (rather than state) shares. In August 2000, the MoF is reported to have informally banned the sale of state shares to non-state entities after a couple of attempts. However, in August 2002, it authorised the transfer of state shares in Fangxiang Guangdian (000757) to a private investor, signalling the end of the ban.\textsuperscript{16} In the first quarter of 2003, 38 of the 44 major non-tradable share transfers announced involved state shares. One was the sale of 48.9m state shares in Yanbian Highway (000776) held by the local state asset management company (and previously by the local transport bureau) to Guilin Jilin Aodong Pharmaceuticals Group for Rmb2.23 a share, a total price of Rmb111.9m ($84.6m). The deal was authorised by the MoF in January 2003. During 2003, 224 listed companies had their state shares change hands in 332 deals; among these, 159 listed companies had their state shares re-registered as non-state shares (either standard LP shares or non-tradable natural-person shares) via 223 deals. However, less than 10bn state shares have been transferred to participation in management. See La Porta, Lopez-de-Silanes et al. (1999). Claessens, Djankov et al. (2000) found similar corporate structures in Asia.

\textsuperscript{11} Chen et al. (2002: 2); Wang et al. (2001).
\textsuperscript{12} Firth, M. et al. (2002).
\textsuperscript{13} Huang, S. and F. Song (2002).
\textsuperscript{14} Aharony, J. and T.J. Wong (1999).
\textsuperscript{15} Nie and Tian (2001: 302–311).
\textsuperscript{16} Chen (2003: 85).
non-state holders, a proportion of just 3.48% of the total number of state shares. State shares will normally be re-classified as LP shares if they have been sold to a non-state entity. Table 2 shows the number of deals between 1993 and 2003 in which enough LP or state shares were transferred to ensure that control changed hands. It is important to note that these deals were not synonymous with privatisation since some of the new owners were not privately-held companies, as explained below. It is also worthwhile noting that there is likely to be as many ‘new’ companies arriving on the Shanghai and Shenzhen boards thanks to these reverse acquisitions as there are through IPOs.

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Table 2. Changes in control at listed companies, 1993-2002

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of changes in controlling shareholders at listed firms</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>9</td>
<td>33</td>
<td>70</td>
<td>84</td>
<td>103</td>
<td>119</td>
<td>168</td>
<td>171*</td>
</tr>
<tr>
<td>Total number of A-share IPOs</td>
<td>130</td>
<td>44</td>
<td>15</td>
<td>189</td>
<td>196</td>
<td>100</td>
<td>101</td>
<td>89</td>
<td>88</td>
<td>97</td>
<td>63</td>
</tr>
<tr>
<td>Total number of listed companies at year end</td>
<td>183</td>
<td>291</td>
<td>323</td>
<td>530</td>
<td>745</td>
<td>851</td>
<td>949</td>
<td>1,088</td>
<td>1,160</td>
<td>1,224</td>
<td>1,287</td>
</tr>
<tr>
<td>Number of take-overs as a proportion of total listed companies, %</td>
<td>0.5</td>
<td>0.7</td>
<td>0.3</td>
<td>1.7</td>
<td>4.4</td>
<td>8.2</td>
<td>8.9</td>
<td>9.5</td>
<td>10.3</td>
<td>13.7</td>
<td>13.3**</td>
</tr>
<tr>
<td>Number of take-overs as a proportion of A-share IPOs, %</td>
<td>0.8</td>
<td>4.5</td>
<td>6.7</td>
<td>4.8</td>
<td>16.8</td>
<td>70.0</td>
<td>83.2</td>
<td>115.7</td>
<td>135.2</td>
<td>173.2</td>
<td>270.9**</td>
</tr>
</tbody>
</table>

Sources: Dongfang Gaosheng (2000); Nie and Tian (2001: 304); Chen (2003: 5); SHGSE (2003: 186) and assorted press reports.
* Figure based on annualising the 128 for Jan-Sept. 2003.
** Estimates based on the 2003 annualised figure.
Why is the supply of non-tradable shares developing so rapidly? There are three main reasons that explain the motives of commercial state entities selling their LP shares, as well as in recent months the growing trend among state asset management bureau to sell their state shares. First, other strategies, including corporate restructurings, a popular phenomenon in the late 1990s, are generally failing to produce sustained improvements in firm performance. Newly inserted assets are often ill-suited to the listed firm or over-valued, while poor management is either not replaced, or has no experience in operating the new assets. Many restructurings have been organised in desperation, to keep the listed firm officially profit making. Once they fail, with few prospects of a reliable dividend in the near future LP owners and provincial state asset bureau have an incentive to sell in order to realise an immediate cash sum. Analysis by Green and Black of controlling block transactions at the SHZSE during 2000-02 found that one in three sellers of control was an SOE, and an additional 27% were limited liability companies and groups, a large proportion of which are likely to be state controlled. This is shown in Table 3.

Table 3. Sellers of control of listed firms at the SHZSE, 2000-02

<table>
<thead>
<tr>
<th>Firm type</th>
<th>Number of deals</th>
<th>Proportion of total, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign-invested enterprise</td>
<td>2</td>
<td>1.8</td>
</tr>
<tr>
<td>Enterprise group</td>
<td>15</td>
<td>13.4</td>
</tr>
<tr>
<td>Shareholding company</td>
<td>4</td>
<td>3.6</td>
</tr>
<tr>
<td>Limited liability company</td>
<td>16</td>
<td>14.3</td>
</tr>
<tr>
<td>Private enterprises</td>
<td>14</td>
<td>12.5</td>
</tr>
<tr>
<td>Other</td>
<td>6</td>
<td>5.4</td>
</tr>
<tr>
<td>State asset management bureau</td>
<td>16</td>
<td>14.3</td>
</tr>
<tr>
<td>State-controlled enterprises (including SOEs)</td>
<td>39</td>
<td>34.8</td>
</tr>
<tr>
<td>Total</td>
<td>112</td>
<td>100.0</td>
</tr>
</tbody>
</table>


Second, improvements in the regulatory environment since 2000 have also encouraged LP shareholders to quit failing firms. The CSRC finally became fully empowered after the National Financial Work Conference of October 1997, gaining control over the regional securities administration offices, being promoted to a rank equivalent to a State Council ministry and also absorbing the regulatory functions of the PBoC over securities firms. The era of provincial-level government control of China’s stock market had come to an end. As a result, the regulatory environment began to change.18 Two new categories – the special treatment (ST) and particular transfer (PT) categories – were created in 1998 and 1999 for firms with two and three continuous years of losses and trading in these firms’ shares was restricted. A delisting mechanism was introduced, raising the possibility that LP shareholders could lose their firms entirely. The CSRC also pushed for higher quality financial disclosures and more severe punishments for illegal behaviour, and with a staff of some 3,000 people...
nation-wide it was better placed to investigate and enforce such actions. Shareholders themselves have also become more active in pursuing managements who commit illegal acts and the government has given them space to do so by making directors financially liable for the accuracy of their financial disclosures, at least in theory.19 Institutional investors are now becoming active in monitoring management and complaining if they believe that shareholder value is being damaged. The regulator has also taken direct measures to weaken the power of LP shareholders, making asset stripping less easy. Given these changes, it has become more difficult (though, of course, not impossible) for LP shareholders to misbehave with their listed firms. Incentives for selling non-performing firms have thus increased. Third, facing hardening budget constraints themselves, owners of non-tradable shares have come under pressure to raise additional working capital. Faced with the need to raise capital, one obvious route is to liquidate assets and if LP shares are not generating dividends now or in the near future, there is little reason not to sell them.

The above analysis explains the supply side of the market: but what explains demand? Who would buy such poorly-performing former SOEs? There are four main types of buyer – government-owned entities, private investors, firm management teams and foreign investors – and each, of course, have their own motivations. Green and Black, in a survey of LP share transactions at the SHZSE during 2000-02, found that just over one in three new owners in cases when control changed hands were private firms, as Table 4 shows

<table>
<thead>
<tr>
<th>Firm type</th>
<th>Number of deals</th>
<th>Proportion of deals in which control changed, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign-invested enterprise</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Enterprise group</td>
<td>13</td>
<td>12.9</td>
</tr>
<tr>
<td>Shareholding company</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Limited liability company</td>
<td>27</td>
<td>26.7</td>
</tr>
<tr>
<td>Private enterprises</td>
<td>35</td>
<td>34.7</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>1.0</td>
</tr>
<tr>
<td>State asset management bureau</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>State-controlled enterprises (including SOEs)</td>
<td>24</td>
<td>23.8</td>
</tr>
<tr>
<td>Total</td>
<td>101</td>
<td></td>
</tr>
</tbody>
</table>


a. State-owned entities

Some buyers are government-controlled firms that buy listed firms to preserve them, in order to ensure that the listing place is not lost, employees laid off, or important assets are lost to firms from rival provinces. Local government firms that failed to win the province’s quota for the IPO place can fulfil their listing ambitions this way. In other cases, state-controlled firms discriminated against in the national investment plan and which have not been allowed to

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19 See Green (2004) chapters 5, 6 and 8.
make IPOs (e.g. financial services, light manufacturing and real estate) make backdoor listings through commercial buy-outs.

b. Private investors

Green and Black, in a survey of LP share transactions at the SHZSE during 2000-02, found that just over one in three new owners in cases where control changed hands were private firms.\(^{20}\) Research by Dongfang Gaosheng supports this finding. Each year during 1997-2002 it found that 20-30% of the recipients of controlling LP share stakes were privately-owned. That proportion has been rising gradually, as Table 5 shows.\(^{21}\) These figures cover all types of transfer. Looking only at the commercial buy-out market (i.e. excluding administrative transfers), 70 of the 88 agreed sales in 2001 (80%) involved a private firm as buyer.\(^{22}\)

<table>
<thead>
<tr>
<th>Year</th>
<th>State-entity</th>
<th>Private company</th>
<th>Unclear ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>63.6</td>
<td>21.2</td>
<td>15.2</td>
</tr>
<tr>
<td>1998</td>
<td>48.6</td>
<td>21.4</td>
<td>30.0</td>
</tr>
<tr>
<td>1999</td>
<td>63.1</td>
<td>21.4</td>
<td>15.5</td>
</tr>
<tr>
<td>2000</td>
<td>62.1</td>
<td>29.1</td>
<td>8.8</td>
</tr>
<tr>
<td>2001</td>
<td>63.0</td>
<td>29.4</td>
<td>7.6</td>
</tr>
<tr>
<td>2002</td>
<td>48.8</td>
<td>33.9</td>
<td>17.3</td>
</tr>
</tbody>
</table>

Source: Chen (2003: 26).

In 2003 private enterprises and natural persons acquired the LP shares of 56 listed companies’, collective enterprises bought three and foreign-invested firms purchased 13. Altogether, these non-state entities gained control of 72 listed companies (via 90 deals), some 45% of all the deals in that year. Private firms have a variety of motives for buy-outs. Some buy control in order to influence the price of the listed shares and turn a fast – and not entirely legal – profit. Many scams have been organised by investment companies that are often little more than fronts for stock manipulators, the classic example being the buy-out and restructuring of Zhongke Chuangye in 1999-2000.\(^{23}\) While a rising number of deals are substantial in nature (see below), many buyers still fail either to endow the listed firm with a new business or to manage it through the required transition to profitability.

A second buy-out motive of private investors is to gain control of valuable, but poorly-managed assets. An example here is Shanghai Zhonglu Group’s purchase in September 2002 of 143.6m state shares in Shanghai Yongjiu (Shanghai Forever, stock code: 600818) from Shanghai Light Industry Group for Rmb34.1m ($4.1m). Zhonglu took a 54.1% stake and the state shares it bought were re-registered as LP shares with the blessing of the Shanghai

\(^{18}\) See Hutchens (2003); Li (2004).

\(^{20}\) Green and Black (2003).

\(^{21}\) Green and Black show that one in four buyers is a limited liability company, a category which includes both privately-controlled and public companies.

\(^{22}\) Nie and Tian (2001: 306).

\(^{23}\) See EIU (2001).
SASAC. The purchase was primarily motivated by Zhonglu’s interest in the Yongjiu brand name, an intangible asset whose value was not included in the official valuation. Since the purchase, the new owner of Yongjiu has downsized the firm’s staff, introduced new bike models, established a licensed-manufacturing operation with Raleigh, a UK-based bike maker, and started producing gas-powered mopeds. The bet is that the firm can leverage the Yongjiu brand to win out in what are already competitive markets. Third, the private buyer might wish to buy out a successful competitor, expand operations to benefit from economies of scale, absorb technology or poach skilled personnel. Taitai Pharmaceutical’s take-over of Lizhu Pharmaceuticals in 2002 is a good example of this.

The buyers of Zhonglu and Lizhu were also most likely motivated by a fourth motive, one which alone drives many acquisitions: the simple desire to obtain a listing vehicle. The targets of most of take-overs do not generate profits, are over-staffed, heavily indebted, lack any assets, tangible or otherwise, and operate in sunset industries. In other words, they present wholly unattractive take-over targets. 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. The result of such a constraint 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 made it profitable, the ‘new’ firm can apply to make a share issue after only one year.

Natural persons as controlling shareholders have become increasingly common. During the first half of 2004, out of 50 already listed or soon to-be-listed firms, 20 were controlled by natural persons. By the end of May 2004, there were 17 natural-persons with shares worth more than Rmb100m ($12 m). Table 6 lists the top eight individuals in terms of the market capitalisation of their shareholdings in the companies listed between January and May 2004.

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24 Interview, Shanghai, April 18th 2004. The Shanghai SASAC was established in the early 1990s and was reorganised following the creation of the central SASAC in March 2003.
26 Amongst 70 companies that made IPOs in 2003, nine were privately owned.
27 Rights issues are usually limited to listed companies which have recorded returns on assets of more than 10% on average for three consecutive years.
Table 6. The top eight private shareholders, and the market capitalisation of their shareholdings as of May 31st, 2004

<table>
<thead>
<tr>
<th>Name of private shareholder</th>
<th>Name of listed company</th>
<th>Stock code</th>
<th>Market capitalisation of stake, $m</th>
<th>Proportion of total share capital owned by the individual, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Li Dongsheng</td>
<td>TCL Group</td>
<td>000100</td>
<td>122.62</td>
<td>5.59</td>
</tr>
<tr>
<td>Lai Zhenyuan</td>
<td>Longyuan Jianshe</td>
<td>600491</td>
<td>109.52</td>
<td>44.97</td>
</tr>
<tr>
<td>Dou Qiling</td>
<td>Yibai Zhiyao</td>
<td>600594</td>
<td>60.31</td>
<td>26.66</td>
</tr>
<tr>
<td>Su Tong</td>
<td>Huasheng Tiancheng</td>
<td>600410</td>
<td>47.50</td>
<td>18.62</td>
</tr>
<tr>
<td>Huang Yizhen</td>
<td>Dongfang Baolong</td>
<td>600955</td>
<td>38.97</td>
<td>27.44</td>
</tr>
<tr>
<td>Wang Weihang</td>
<td>Huasheng Tiancheng</td>
<td>600410</td>
<td>35.77</td>
<td>14.15</td>
</tr>
<tr>
<td>Ye Xiangwu</td>
<td>Yibai Zhiyao</td>
<td>600594</td>
<td>32.04</td>
<td>14.03</td>
</tr>
<tr>
<td>Liu Jianzhu</td>
<td>Huasheng Tiancheng</td>
<td>600410</td>
<td>30.40</td>
<td>11.91</td>
</tr>
</tbody>
</table>

* Market Capitalisation of Shareholding = Closing Price as of May 31 2004 * Number of shares owns by the private shareholder

c. Management buy-outs

Dozens of listed companies have attempted to organise MBOs. Managers (and sometimes employees) usually form a joint stock limited liability shell company to act as a vehicle for the buy. However, since the Company Law restricts investments to less than 50% of a company’s registered capital, in all but one of these cases, the investment appears to have been illegal. Management’s shareholding was usually maintained below 30% to avoid the need to make a tender offer, as required by CSRC regulations. The majority of the deals were done through agreed sales at or below the firm’s NAV. In roughly half of the cases, shares were bought in the listed firm; in the other half, shares were acquired in the major shareholder(s) of the listed firm. After an initial burst of enthusiasm for listed company MBOs within the CSRC and in central government in 2001-02, support has since cooled due to the suspicion that many deals allow extensive asset stripping. In March 2003, the MoF banned MBOs, and the SASAC officials appear to be no keener on allowing them.

d. Foreign investors

- There have also been a number of foreign acquisitions of LP shares enabled by two CSRC notices in 2001 and 2002, (although a number did take place during 1995-01 when an informal ban on non-tradable shares sales to foreign investors was in place). Foreign buyers have a variety of motives, though the prime ambition is usually to gain control of tangible and non-tangible assets rather than a listing vehicle. Examples include:
  - The acquisition by Newbridge, a private equity firm based in San Francisco, of a 20% stake in the Shenzhen Development Bank from the Shenzhen government, a controlling stake, for an estimated $150m in May 2004.

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28 PRC Company Law, 1993, Article 12 read ‘In case a company, other than an investment company or a holding company as specified by the State Council, invests in other limited liability companies or joint stock limited companies, the aggregated amount of such investments shall not exceed fifty percent of its net assets…’

30 Notice on the Issue of Selling Listed Company State and Legal Person Shares to Foreign Investors, issued by the CSRC, MoF and SETC, November 1st, 2002.
In December 2003, Scottish & Newcastle agreed to acquire 50m state shares in Chongqing Brewery from its parent Chongqing Beer Group for Rmb10.5 a share, a premium to the listed firm’s shares' NAV at the end of September 2003 of Rmb2.50.

After an intense competition with SABMiller (which bought a 29% legal person share stake in Harbin Brewery in mid-2003), Anheuser-Busch bought both SABM’s shares and those still held by Harbin City government for a total stake of 70%. The price, HK$5bn ($), valued the Hong Kong-listed brewery at 50 times 2003 earnings.

Quite a few overseas acquisitions took place at the parent or subsidiary level as opposed to the listed company level. Danone, for instance, acquired a 50% stake in Meilin Zhengguanghe (whose core business is in non-carbonated soft drinks) from the listed company Shanghai Meilin (600073).  

Transfer methods, prices and payment options

Transfers of LP and state shares can occur in a number of ways. Research by Green and Black shows that agreed sales are by far the most common form of transferring control, as Table 7 shows. There has not been much variation in the breakdown of sales methods during 1997-2002.  

<table>
<thead>
<tr>
<th>Method of transfer</th>
<th>Number of deals</th>
<th>Proportion of deals, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agreed sale</td>
<td>71</td>
<td>63.4</td>
</tr>
<tr>
<td>Free transfer</td>
<td>20</td>
<td>17.9</td>
</tr>
<tr>
<td>Judicial decision</td>
<td>9</td>
<td>8.0</td>
</tr>
<tr>
<td>Forced implementation</td>
<td>12</td>
<td>10.7</td>
</tr>
<tr>
<td>Total</td>
<td>112</td>
<td>100</td>
</tr>
</tbody>
</table>


The different methods of transfer are:

**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. Such deals normally take place in parallel with a debt restructuring.

**Free transfer (guquan zhuanran or wuchang huabo).** About one fifth of the changes in corporate control in 2000-02 – less than in previous years – involved the administrative transfer of LP and/or state shares from one government organ to another. These transfers usually come about as the result of a reorganisation of the responsibilities of parts of the government bureaucracy. Such transfers do not usually involve cash.

**Judicial decision (sifa caiding).** Almost one in ten of the changes in ownership in 2001 involved the transfer of shares as a result of a court judgement. These usually involve an...
insolvent LP shareholder being forced to sell its LP shares at auction after which the revenues are collected by the creditor(s). Forced implementation is similar to the court-ordered auction, but involves a company which has used its shares as collateral for a bank loan going into default and the shares being transferred to a party nominated by the bank.\(^{33}\)

In most cases, deals involving the transfer of control are negotiated in talks between the LP share owners, the listed company, its provincial government and the potential buyer.\(^{34}\) Auctions have also been used for LP sales, particularly for the transfer of small stakes.\(^{35}\) The auction market boomed in 2001 with speculation about a move to allow them to list and trade freely causing many professional investors to travel the country buying up LP shares and then selling some or all of them off in small batches at auction in Shanghai, Shenzhen and Beijing. One interviewee estimated that there were a few hundred LP share transactions a day being registered in mid-2001, with prices for LP shares in many listed companies being commonly recognised nation-wide.\(^{36}\) Various brokers’ websites posted prices. However, in December 2001 the CSRC moved against the auction market. Since then, any transaction of non-tradable shares of less than 5% of the total share capital of a listed company has had been specially authorised by the CSRC.\(^{37}\) This more or less ended the auction market in listed company shares since permission was rarely given.\(^{38}\) There were two reasons for this de facto ban. First, the frequency and the scale of auction transactions meant that they were beginning to challenge the stock exchanges as a site of share trading. Given the small size of the stakes, the use of computerised auction systems in some places and the large volumes of capital involved, this was not an unreasonable assumption. Some analysts believed that the auction market was adding to the downward drift of listed share prices (a particular concern in the second half of 2001 when the market was in decline).\(^{39}\) A second reason was that in a small number of cases, large LP share stakes were split up into smaller lots and then sold at auction. This allowed buyers to accumulate control at a low price (since state assets sold at auction do not require the NAV to be used as the price floor) and without having to gain the MoF’s approval (since auctioned state assets do not require such approval).

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\(^{33}\) The Commercial Bank Law prevents banks owning shares in their own name, so they use nominees who take legal trust of the shares, pass dividends onto the bank and who represent it on the board.

\(^{34}\) Lang and Zhang (2002); Dongfang Gaosheng (2000). Only a handful of hostile acquisitions involving listed companies have taken place. The first, and most famous, case of a hostile take-over in China’s stock market involved the purchase of Shanghai-listed Yanzhong Industries by Bao’an Industries, a Shenzhen firm in 1993.


\(^{36}\) The Shenzhen Clearing & Settlement Company was reportedly registering about 70 transactions a day, Shanghai more, while five provincial sub-offices where deals could be registered were all also active.

\(^{37}\) Transfers of stakes between 5% and 30% remain outside the CSRC’s authorisation remit (on which more below).

\(^{38}\) Informal trading, including auctions, in unlisted company shares still takes place in many parts of China. See Liu and Green (2003).

\(^{39}\) Interview, Shenzhen, September 19\(^{th}\), 2003.
According to Green and Black, in deals that resulted in a change of control at the SHZSE during 2000-02, the average number of shares transferred was 48.5m, an average of 20% of the target company’s share capital. Almost one half of the deals in 2001 in which ownership changed hands involved a stake of between 20% and 30% being transferred, as Table 8 shows. One third of the total transfers involved stakes of more than 30% of the listed firm’s shares. A number of these were sales mandated by the courts or were administrative transfers. However, the majority were agreed sales.

Table 8. How much share capital is transferred when control changes hands?

<table>
<thead>
<tr>
<th></th>
<th>Above 50%</th>
<th>30%-50%</th>
<th>20%-30%</th>
<th>10%-20%</th>
<th>Less than 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of companies</td>
<td>12</td>
<td>26</td>
<td>63</td>
<td>27</td>
<td>6</td>
</tr>
<tr>
<td>Proportion of total, %</td>
<td>9.0</td>
<td>19.4</td>
<td>47.0</td>
<td>20.1</td>
<td>4.5</td>
</tr>
</tbody>
</table>


Note: These figures include only deals in which ownership changed hands, including deals based on agreed transfers, administrative transfers and court-mandated transfers.

LP shares change hands at a considerable discount to listed shares, primarily because of their restricted liquidity (and the premium that liquidity gives tradable individual shares). The LP shares of acquired firms tend to be unusually cheap since these companies generally have poorly-performing businesses. The average per share income (PSI) of the 130 companies that underwent a change in their controlling shareholder in 2001 was Rmb0.04, significantly below the market’s average PSI that year of Rmb0.14. The reasons for this are, of course, that buyers are interested in distressed (and therefore cheap) companies and that the LP shareholders of more profitable firms are less willing to sell.

However, there are important administrative restrictions on how low prices can go. Ministry of Finance regulations require that state assets may not normally be sold for less than their net asset (i.e. book) value. With the NAV as the official floor, the parties negotiate the size of the premium, which depends on a number of factors including the target firm’s profitability, the value of its non-tangible assets, the ease with which the workforce can be downsized, etc. Nie and Tian looked at take-over deals between 1998 and 2001 and found that two-thirds of them were priced at a premium of 20-30% on book value, a tenth were bought at the NAV price itself, and a quarter were priced below book value (possible since some deals were done at auction, where the NAV does not apply). Research by the Shanghai Stock Exchange (SHGSE) shows that the majority of deals during 1997-2001 took place at a 0-30% premium to the NAV, while a large number also occurred at higher prices.41

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40 Nie and Tian (2001: 303-308).
It is important to note that in many instances, the buyer determines that the official NAV overstates the actual value of the firm. In such cases, it is not uncommon for the local government to quietly offer additional inducements (preferential access to cheap bank credit, for instance) to the firm after the sale, thus reducing the de facto price of the transaction.42

<table>
<thead>
<tr>
<th>Table 9. Premium paid on NAV, 1997-2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average price of transaction, Rmb m</td>
</tr>
<tr>
<td>Average premium paid on NAV for acquired listed companies, %</td>
</tr>
</tbody>
</table>

Source: Chen (2003: 7).

Dongfang Gaoshang found prices for control rising during 1997 to 2002, from Rmb64m to Rmb202m, as Table 9 shows. However, there also appears to be a downward trend in the premiums paid on the NAV during 1997-2002. What explains this? First, the quality of listed targets has improved. As the non-tradable share market has developed, the number of terrible (and cheap, at least in terms of share price) shells available has declined, forcing prospective buyers to acquire better firms. In addition, in recent years, demand for shells has risen while the supply is plainly limited. Because of this prices have risen. However, since the underlying NAVs of the targets have also risen, the premium to be paid on these NAVs has fallen as buyers seem to be sensitive to the absolute price paid, perhaps because of financial constraints.

In developed markets, acquisitions are usually financed using a combination of retained earnings, bank loans, debt and shares. However, in China they are still mostly a cash business, with that cash coming mostly from retained earnings.43 Because of cash-flow constraints, it is common for purchasers to delay their payments or to pay in instalments. Banks are not currently permitted to lend to purchasers since this would contravene the ban on their involvement in securities-related transactions, though in practice much informal lending for these acquisitions, often via intermediaries, does appear to go on.44 Non-bank financial institutions, particularly TICs, are exempt from the official financing ban and have become a source of funds for MBOs and some other leveraged deals. For instance, in the Jiqinggong (000546) buy-out deal, buyers Changchun Chuangshi and Changchun Hengshun signed agreements with Jilin Asia TIC for loans worth Rmb92m ($11.1m) and Rmb78m ($9.4m), respectively.45 In MBOs, the purchased shares are generally used as collateral on which to borrow money from the TIC. The expectation is that a subsequent rights issue by the

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42 Interview, Beijing, April 2003.
43 Some share swaps have occurred since 1998, but to the author’s knowledge none have involved listed firms. See Chen (2003: 88).
44 Interview, Shenzhen, September 2003.
newly-acquired firm, in addition to its own retained earnings, will raise enough cash to pay off the loan.

Non-cash payments are still rare. Permission to issue corporate debt is difficult to obtain generally and until late 2002 shares were not permitted to be used as a form of payment in acquisitions. Any additional issue of shares needs to be authorised by the CSRC and involves a fairly lengthy application process. In general, it is likely that the number and size of acquisitions have been constrained by the lack of financing options available.

In more mature markets like those in the United States and United Kingdom, M&A regulation tends to be focused on the protection of minority investors and the full disclosure of relevant information. In China, while these elements are clearly becoming increasingly important (as development of the tender offer framework shows), more emphasis is still placed on the need for administrative approval. Both the transfer of state assets (including shares owned by state organs) and the restructuring of listed firms require approval from state organs. This approval-heavy approach is aimed at preventing the theft of state assets, but in practice it creates opportunities for other forms of corruption as well as uncertainty in the take-over process.

The first set of rules governs the transfer of shares themselves. This is based first on the nature of the shares (LP or state), second on the identity of the seller and buyer (a public or private entity), and third on the administrative level of the firm in question (central or local government). The system also changed in 2003 with the creation of the SASAC. Any transfers of state shares in central-level firms, have had to be authorised by the central government – up until March 2003 the MoF’s SAMB, and afterwards the SASAC. This was because of the SAMB/SASAC’s ownership of these shares. Before 2003, the transfer of state-owned LP shares held by provincial-level firms was authorised at the local level, while those held by central entities were authorised by the central authorities. Now, central-level authorisation is also required for transfers of LP shares owned by state entities, at both the central and local levels, this requirement being triggered by the nature of the owner of the shares, rather than by the nature of the shares themselves. Local SASACs’ authority is limited to authorising the transfer of provincial-level organs’ state shares in non-listed companies. If non-state-owned LP shares are to be transferred, then the local Industrial and Commercial Bureau is the only organ that needs to grant permission; the share transfer is then simply registered with the settlement and clearing company at the relevant stock exchange.

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46 The CSRC’s November 2002 M&A Regulations permitted their use but, to the author’s knowledge, no listed company acquisition had, by the time of writing, used this method.

47 On July 1st, 2000, the MoF attempted to clarify the division of powers by issuing Measures on Several Problems Encountered in the State Share Management Work Involving Share Limited Companies
A second set of rules governs the restructuring of listed companies and is oriented towards protecting investors from ‘fake’ acquisitions. However, the CSRC has had difficulties balancing the need for administrative review with more a market-oriented reliance on disclosure. After a number of attempts, in its September 2002 Listed Company Merger and Acquisition Management Measures, hereafter M&A Regulations, the CSRC required that all deals involving a change in the ownership of more than 30% of a firm’s assets need to seek its authorisation after being passed by the firm’s board of directors and shareholders’ meeting. In addition, in May 2002 the CSRC established a ‘restructuring authorisation committee’ to oversee applications by current and new shareholders for any restructuring involving more than 50% of a firm’s assets. This was designed to ensure that deals were substantive, rather than speculative, in nature.48

**The impact on performance of two-thirds privatisation**

In principle, privatisation should improve medium- and long-term firm performance. Many analysts, however, suspect that the majority are organised in order to manipulate the target firm’s share price, strip the listed firm’s assets and/or to gain quick access to funds from a rights share issue. The evidence at present is not conclusive, though current developments are in the right direction.

Certainly, an initial comparison of the performance of public and privately-controlled listed firms suggests that the former outperform the later. Cui Hongxia found evidence of take-over deals leading to progressively worse outcomes. 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.49 However, companies bought during 2000-01 did not experience any profit growth in the year(s) following the deal.

There are signs that the quality of take-overs are improving, however. The CSRC is becoming better equipped at identifying and preventing fake acquisitions, and in punishing those involved in organising them. 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.50 One interviewee noted that the decline in market prices during 2001-03 has also reduced incentives for manipulation-based buy-outs: with prices so low it is extremely hard to make money on such scams.51 Two professional share investors familiar with the LP market also argued in interview that speculation was much reduced.52

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48 The CSRC’s 2002 M&A Regulations also created a framework for tender offers.
49 Cui (2002).
50 As of the time of writing, no judgement had been passed.
51 Interview, Shenzhen, September 2003.
52 Interview, Shanghai, April 18th 2004.
An increasing proportion of purchasers of listed companies are companies with substantive businesses which they are ready to insert into the shells they buy, rather than investment companies who are more likely to artificially repackage the company for speculative purposes. There is also evidence that fewer shells are being purchased just to enable the buyer to make a rights issue. In 1997, 48.5% of the 33 bought-out companies were qualified and ready to make rights issues. That proportion dropped to 25.6% in 2002. A simple comparison of public and privately-controlled firms suffers from selection bias – private companies under-perform because they were bought out for that reason. Cui Hongxia's finding – of no profit growth in the year(s) proceeding the acquisition – may be interpreted as indicating that proper restructuring is taking time to bed down. Research by Zhang Xin supports the case for acquisitions creating value for the stock market. He found that share prices of target companies recorded better performance compared with the market as a whole (an average premium of 29.05%, higher than the international level of 20%) over a period of sixty days before the announcement of the take-over to thirty days afterwards. He also discovered substantive improvements in firms' performance after such take-overs. The profit rates of the core businesses (operating profit/gross sales from core business) at acquired companies rose from an average of 23% in the year of the deal to 26% two years later. He argues that this suggests that acquisitions have a beneficial impact on firm performance. This evidence is highly suggestive, though the fact that most acquisitions took place in recent years means that a definitive answer is not yet available.

**Improving the LP share market – and lessons for the state share sell-off**

While the evidence on performance is mixed, with better regulation in place it seems likely that increasingly the sale of LP and state shares into private hands will result in improved performance. Together with better enforcement of disclosures and corporate governance, privatisation of control is likely to be the best future for China’s stock market. Two issues are raised in this concluding section. While the LP share market is facilitating the quiet and gradual privatisation of China’s state-controlled listed firms, this privatisation ‘two-step’ – incorporation and listing followed by an off-market transfer of a controlling stake – there are questions over whether this is the best way of reforming China’s large enterprises. Second, given the quiet and mostly successful evolution of the LP share market, what lessons can be drawn for the liquidation and sale of LP and state shares, a priority issue for the leadership of both the CSRC and SASAC.

Organising the privatisation of large firms as a two step process has a number of advantages. It allows property rights to be clarified, laying the foundation for ownership transfer at a later date, at a time when privatisation is politically more digestible. It generates considerable financial resources, both for the firm at the IPO, and for the parent at the sale of the LP

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53 Chen (2003: 18).
shares. Although direct sales are not ideal, one-to-one negotiations allow for a comprehensive assessment of a firm’s business and finances to be carried out, and for particular issues (how to deal with debts, employees etc.) to be discussed and agreed in detail. And finally, since the share transfer is off-market, privatisation at the second step can occur without having a disruptive impact on the value of the listed shares.

However, organising ownership transfer this way also has important disadvantages. First, it involves a significant period of time in which control rights remain in the hands of state representatives, and this tends to have a detrimental effect on performance and governance standards. Second, while revenues are generated from the sale of LP shares it is not the government budget that benefits, and it is local government budgets which benefit from the sale of most state shares. This has consequences for the state’s fiscal health since funds raised from non-tradable shares can not be currently used for resolving the state’s large liabilities. Some means of allocating more funds to a dedicated central fund, perhaps for pensions, would be worthwhile. Third, forcing the private sector to finance the restructuring of state industry is not economically efficient. Although some substantive assets are sometimes purchased, much of the money paid in these acquisitions is a de facto tax on access to the stock market. Fourth, the acquisition process is vulnerable to abuse. Deals negotiated behind closed doors without an open auction or tender process tend to be vulnerable to corruption. And finally, the NAV price floor rule encourages corruption in the case of over-valued firms (since side payments have to be made to facilitate deals) and the loss of state assets in the case of under-valued firms (since intangible assets, such as brands and sales networks, are not included in the official valuation).

Over the next five years – if it continues in its present form – the two-step privatisation process could be improved in a number of ways. First, the period between the IPO and the transfer of control could be shortened, with strategic sales of large stakes before the IPO to outside investors, something that often happens in other markets. Ownership change at this early stage would be an important step forward, even though the tradability issue would still have to be resolved. Second, in terms of the sale method, auctions tend to be a more transparent and fair means of selling off large blocks of assets than the current fashion for direct sales. Despite the particularities of these deals, an open invitation for offers, such as what now occurs at the Property Rights Transaction Centres for non-listed state assets might encourage better quality sales. Third, allowing greater flexibility for financing acquisitions – for example allowing companies to issue bonds to make leveraged buy-outs – would be helpful, though this needs to be carefully regulated to prevent abuse. Fourth, revenues from LP share

54 Zhang (2002).
55 The only exception to this at present are the 10% of IPO revenues allocated from overseas IPOs to the National Social Security Fund since July 2001.
56 One interviewee familiar with the market estimated that one in three deals were organised for less than NAV, Interview, April 23rd 2004.
sales might best be shared between local government budgets and the selling shareholder in order that the government budget benefits from these sales, rather than just their state LP share owners. Fifth, although MoF resistance is fierce, introducing more flexibility on pricing is crucial. Removing the NAV floor while at the same time introducing more competitive pricing mechanisms (e.g. auctions) would ensure that the state’s revenue from LP share sales are maximised.

A second issue is that of tradability. The State Council’s *Nine Articles on the Development of China’s Capital Market*, released in February 2004, signalled to many the commitment of the senior leadership to tackle the non-tradability issue. The LP share market holds at least three useful lessons for how the issue might best be dealt with. First, allowing state share sale deals to be organised on a one-by-one basis, by the firms themselves, their shareholders, as well as by local officials, is preferable to a ‘one-national-scheme-fits-all’ approach. The scheme might involve the allocation and/or sale of state shares to LPs and/or individuals, the total or partial sale or transfer of state shares to the National Social Security Fund (NSSF), and/or sale into the market. A second lesson is the importance of allowing the market to set the price. In July-August 2001 state shares were sold at the same price as IPO shares, at price-earnings ratios of 15 or above (i.e. well above NAV), which the market found difficult to accept. The success of the LP market suggests that a market-based pricing method – even if NAV is used as a floor – would work better. A third lesson is the importance of timing the liquidation. This might involve a variety of policies. The number of companies allowed to go forward with sales would have to be limited – even if they are self-selecting. There might be cause to restrict the tradability of state shares for a time after their conversion into individual shares.

Current thinking within the CSRC suggests that these ideas are indeed on the agenda. As of April 2004, senior CSRC officials were reported to be backing a sell-off scheme in which each listed company and its advisor proposed their own method and timetable. Both tradable and non-tradable shareholders would then vote on the sale scheme separately, a double-majority meaning a formal application could then be lodged with CSRC and SASAC. At the time of writing, the proposal was still being discussed (with the SASAC reportedly reticent to offer shares at a discount), and if passed, a few experimental sales, involving several of the better quality companies, would take place. During early 2004, a number of listed firms and their

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57 In July 2003, the SASAC was reported to be drafting regulations on the transfer of state shares. One report in early 2004 suggested a ‘3/3 treatment’ might be used, in which 30% of the state shares (and possibly state LP shares) by book value are given to the holders of A-shares; 30% is transferred to the National Social Security Fund; and 30% are sold on to the secondary market by the SASAC and are immediately tradable. This leaves 10% non-tradable. See ‘Guoyougu jianchi changwai weixian ziben dazhao bayue denghou’, *Xinlang Meiti*, January 5th 2004, [http://www.mergers-china.com/news/detail.asp?id=11801](http://www.mergers-china.com/news/detail.asp?id=11801).

58 Interview, Beijing, April 2004.

59 During early 2004, a number of listed firms and their securities companies (backed strongly by their provincial governments) submitted plans and applications to the CSRC. In March
The two ministry-level commissions reportedly disagree on a range of issues:

- The CSRC wants to ensure that state shares are involved in the liquidation scheme. The SASAC would prefer that the scheme only initially involves LP shares. This would allow the SASAC to excuse itself completely from the scheme, allowing CSRC officials to take any blame.
- The SASAC is interested in maximising the proceeds from the sale of shares while the CSRC is interested in minimizing the costs of the flotation, to avoid a negative reaction from the market. The level of prices, and the method by which they are set, are therefore contentious issues.
- Any sale of state shares means that the SASAC would lose control over many listed companies. SASAC is therefore suspected of resisting any settlement. For their part, CSRC officials are reported to be pushing to start with an experiment as soon as possible.

However, the LP share market also raises the issue of whether a move to liquidate and sell state shares is the most pragmatic means of developing China’s share market and improving the performance of the firms listed there. What is crucial for performance, at least as far as the former Soviet block experience suggests, is transfer of control. Moreover, it is LP shareholders, not the usually passive state shareholders, who present the major problem, as explained above. Selling state shares into the open market would likely not result in control rights changing hands since they would likely become dispersed and the LP shareholder would remain dominant. Transferring them to the NSSF would also likely have limited impact on the power of the LP shareholders since the fund would be too stretched to take an active role in the board of each firm. The LP share market is at present achieving transfer of control on a significant scale and it is not clear that a sale of state shares would guarantee improved corporate governance and performance at listed firms. Second, any proposal to sell state shares is risky. However one frames the proposal, there is a chance that it will have a hugely negative impact on prices. As a result, it will be politically very difficult to win agreement at senior levels on a sell-off plan. Given the risks and the lack of a guarantee that a state share sale at this stage would result in better governance, a better strategy for the CSRC might well be to allow the majority of listed companies to have their LP shares pass into the private sector and to leave the state share issue alone, at least for the present. As long as state

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2004, Jilin Aodong (000623), a pharmaceuticals company, and several other listed companies submitted its proposal. It is reported that Aodong proposed selling its state shares to A-shareholders at a price no lower than the their net asset value, and making its LP shares fully tradable after a 1:1.7 reverse split. In other words, a LP shareholder with 1,700 shares would end up with 1,000 shares which were re-registered as A-shares and be freely tradable. Although the market reacted to these plans positively, the CSRC and SASAC rejected the applications.
shareholders remain passive and the CSRC continues to tighten regulation to ensure that private owners are not able to strip their firms of assets, firm-level performance improvements over the next five years are likely. Once this has occurred there will be an opportunity to liquidate the state’s passive shareholdings in what are profit-generating, privately-controlled firms. This will still be difficult – but it will be a policy challenge of a different order of magnitude from that facing CSRC and SASAC officials at present.

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60 Interview, Shanghai, April 23rd 2004.
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