Chapter 5 Privatization of State -owned Enterprises: Prospects after the "Socialist Market Economy"

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Introduction

What is the definition of Socialism? Conventionally it is understood to mean a system where all or most of capital as a means of production is owned by the state. In China, however, under Deng Xiaoping's pragmatic banner of "Economic development is our priority above anything (*Fazhan caishi yingdaoli*)," ownership of capital has become pluralistic, overriding the conventional framework of Socialism.

Since the mid 1990s, the presence of private and foreign-capital companies has grown rapidly as China made great strides in its transition to a market economy, which in turn has significantly attenuated the Chinese Communist Party's insistence on state ownership of capital. The resolution of the 16th National Congress of the CPC to recognize admittance of private entrepreneurs into the Party symbolizes the change in party line towards the system of ownership. This National Congress session basically eliminated what had been left of the political restrictions against ownership system reform.[1] Privatization of state-owned enterprises, the final stage of ownership system reform, has been launched as an official policy in 2001. Economic reforms in China from now onward will likely develop with the privatization of large enterprises as the central issue.

Compared to privatization of small and medium sized enterprises, which has already made a substantial progress, privatization of large-scale enterprises involves several complicated issues. One of the important issues is what kinds of agent are going to take initiative in the process of privatization, i.e. who buys enterprises to be privatized and controls them thereafter. Those who take initiative in the privatization process need to be capable of providing effective monitoring of the corporate management after privatization.

In this context, this chapter will cover the recent chain of events in the privatization of large enterprises, focusing especially on companies listed on the stock exchanges.[2] With the setback in the policy for market sales of state-owned shares (*guoyou gu*), the focus of large company privatization has shifted to purchase by strategic investors as the main constituents. In this chapter, we shall investigate institutional investors, management executives, private companies, and foreign-capital companies, as agents which will take initiative in the process of privatization.

5.1 The Tide of Large Enterprise Privatization

5.1.1 Origins of the Divestiture Policy of State-owned Shares

(1) From Conversion to Joint Stock Corporations to Complete Privatization

Since the start of the 1990s, China has been promoting the creation of joint stock companies and the listing of stocks on stock exchanges for comparatively large state-owned companies. The tempo of stock listing has accelerated since 1996 when transformation of state-owned enterprises into joint stock corporations was firmly established as a part of the Party's official policy line (Table 1). The majority of the companies currently listed are joint stock companies that were established through the reorganization of state-owned enterprises.

As was the cases with privatization of large public enterprises in market economies, transformation from a state-owned company into a joint stock corporation and stock exchange listing are usually the first steps to-

Table 1 Development of Stock Listing and Composition of Stock Types (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Number of companies listing stock	51	180	290	322	529	744	851	949	1,088	1,160
Market capitalization (100 mil. RMB)	n.a.	3,531	3,691	3,474	9,842	17,529	19,506	26,471	48,091	43,522
Negotiable stock total	31.9	28.8	32.9	41.3	35.2	34.6	34	35.2	36.6	36.6
A share	15.4	16.8	20.9	21	21.9	23	24.1	26.9	29	25.7
B share	16.5	6.4	6.1	6.7	6.4	6.4	5.4	4.3	4.2	3.1
H share	0	5.7	6	7.7	6.9	5.2	4.5	3.9	3.5	6.4
Non-negotiable stock total	68.1	71.2	67.1	64.6	64.8	65.4	66	64.8	63.3	65.3
State share	44.6	48.1	42.7	38.9	37.7	35.4	34.3	31.6	37.1	46.2
Legal persons' share	22.1	21.3	23.1	24.5	24.9	26.7	28.2	29.6	24.9	18.3
Others	1.5	1.7	1.3	1.2	2.2	3.3	3.4	3.6	1.3	0.8
Grand total	100	100	100	100	100	100	100	100	100	100

Source: *Zhongguo Shangshi Gongsi Jiben Fenxi 2000*, edited by Zhongchengxin Guoji Xinyong Pingji Youxian Zeren Gongsi, Zhongguo Kexue Jishu Chubanshe, 2000; and the website for the China Securities Regulatory Commission

wards complete privatization. In the case of China however, the circumstances are different. Regardless of the officially claimed aims, the principal goal that motivates stock market listing is capital procurement through the stock markets, and it is not the case that complete privatization has been assumed as the target from the beginning. In fact, even though the number of company listings on the stock markets is increasing, the ratio of state shares (*guojia gu*) held by the government is hardly declining. If the state-owned legal entity shares (*guoyou faren gu*) are included, state-owned shares in the broadest sense account for about 60% of issued shares.

In this chapter privatization of large companies implies the sales of all (or a major part of the) state-owned shares in joint stock corporations with state-owned parent companies, to the private entities. Promotion of privatization through sales of state-owned shares has come into prominence with the opportunity of the previous 15th National Congress of the CPC (held in September 1997), and has initiated as an actual policy based on the Resolution of 4th Plenary Session of the 15th CCCPC (held in September 1999). As the Party basically abandoned in effect its previous persistence on state-ownership of capital at this National Congress, move towards complete privatization has been established as a de-facto official policy line. Let us overview how this policy came to be.

At the 15th National Congress in 1997, the idea of "strategic adjustment of the state-owned economy" was first put forward in the report of the General Secretary. While maintaining and strengthening the controlling position of state-owned capital in the "important industries and fields relating to the survival of the national economy," this policy allowed for withdrawal of state capital from the other, non-strategic, industries and fields. The line between strategic and non-strategic fields was less than clear-cut, which offered considerable leeway to more widespread privatization. With this opportunity, privatization of small and medium enterprises under the jurisdiction of local governments got into full swing.

Strong resistance inside the Party, opposed to the policy line of "strategic adjustment," still remained then. At the 4th Plenary Session of the 15th CCCPC held in September 1999, however, the Party reconfirmed the promotion of the strategic adjustment, and narrowed down further the fields where state capital control was to be maintained. Furthermore, the divestiture policy of state-owned shares was clarified as, "select a few stock listed companies in which the state is the major shareholder, and where confidence is high and the growth potential great, and sell a part of the state-owned shares on the premise that control by the state capital is maintained." In response to the Party resolution, the Ministry of Finance presented the targets of reducing the ratio of state-owned shares (including state-owned legal entity shares) in listed companies belonging to non-strategic industries to 51% in the first stage, and 30% in the second stage. The divestiture of state-owned shares was thus established as a government policy.

The policy line of "strategic adjustment," entailed the withdrawal of state ownership from non-strategic areas and participation and promotion of non-state ownership, while at the same time, at least in principle, strengthening state ownership in strategic areas. Notwithstanding what is said by the slogan, actual development reveals that the Party and the government are inclined to place more emphasis on pushing through privatization on an extended scale. In the "10th 5-year Plan Industrial Restructuring Vision" proclaimed by the State Economic and Trade Commission in October 2001 as the guideline of industrial policy for the 10th 5-year Plan period, a policy line was set forth that went a step beyond the 4th Plenary Session resolution on the distribution of state capital (Table 2). The vision emphasizes control through state ownership only on the "core field" of the munition industry, while the overall message was apparently meant to be promoting entry of non-state capital to a wider range of industries.

(2) Background for Policy of Sales of State-owned Shares

There are two major objectives that induced the Party and the government to embark on the drastic policy of promoting privatization through sales of state-owned shares.

Correction of flaws in corporate governance

The average rate of state-owned shares in listed companies is around 30% to 40%, and in not a few cases the ratio is over 50%. The government bureau concerned or the parent state-owned company usually exercises the shareholder authority for state-owned shares. When the government bureau exercises the shareholder authority, the risk of intervention in the company's management by the bureau is substantial. In the event that the shareholder authority for the state-owned shares is entrusted to the management, the risk of insider control increases due to the fact that the management is able to monopolize the company's decision-making process as the representative of the largest stockholder. In order to rectify this kind of situation, it is essential to reduce the rate of state-owned shares and introduce third-party shareholders that can effectively monitor the management.

Procurement of funds for re-capitalizing public pension fund

However, the start of the drastic policy of selling state-owned shares, beginning at the end of 1999, was due more to the pressing need for procurement of funds through sales, rather than for the original purpose of correcting the flaws in corporate governance.

From the end of the 1980s, China has been constructing a social security system centered on pensions. The government has been putting great effort on building the public pension system in order to prepare for the rapid aging of society brought about by the one-child policy. The new pension system transformed the pay-as-you-go system (system that finances pension expenditures to pension recipients through the collection of insurance premiums from people currently in the workforce), into a system principally composed of the fully-funded system (system that uses reserves built up during a worker's working years for government funding of pensions after retirement).

The problem is how to finance pension

Table 2 Evolution of Policies Related to Allocation of State Capital

	Policies Related to Allocation of State Capital
15th National Congress Report (Sept. 1997)	- Maintain dominant position of the state capital in industries and sectors that are vital to the national economy. - In other areas, strengthen priority issues and improve overall standards of state assets through reorganization of assets and structural adjustment.
Resolution of Fourth Plenary Session of the Fifteenth Central Committee of CPC (Sept. 1999)	- In general, industries and sectors that should be controlled by the national economy are as follows: industries that are connected with national security, natural monopoly industries, industries that supply important public goods, and important enterprises affiliated with core industries and high-technology. - In other areas, strengthen priority issues and improve overall standards of state assets through reorganization of assets and structural adjustment.
Policy Vision for Industrial Structural Adjustment for the 15th 5-year plan period (Oct. 2001)	- State capital must maintain absolute control of core sectors of national defense industries. - In sectors that provide important public goods as well as natural monopoly sectors, it will be necessary for state capital to have a dominant position for the time being. In such sectors as electrical supply networks, steam supply, waterworks, gas, tree cutting and transport, land petroleum, valuable metals, and rare and rare-earth metals, state capital will continue to control capital in priority industries. At the same time, introduction of non-state capital will be promoted, and the operational efficiency of capital will be improved. - In sectors that manifest the country's overall strength—such as petrochemicals, automobiles, information industries, machines and equipment, and high-technology—state capital will continue to have a dominant position in a small number of state enterprises. At the same time, joint development of a variety of economic elements will be encouraged. - In strategic fields that manifest the country's competitive power—such as information technology, biotechnology, new materials technology, and advanced manufacturing technology—state capital will serve to guide and promote. In general, the national government will not participate in construction of factories by releasing capital; instead, it will support procurement of project capital, basic research, and applied research, and through these policies, it will promote general investment and international capital investment. - In general strategic sectors, efforts will be made to raise the operating efficiency of state capital as well as overall standards primarily through market mechanisms.

Note: Sections (1) and (2) are translated in full. Section (3) is an abridged translation of relevant sections.
Sources:
(1) Guojia Jingji Tizhi Gaige Weiyuanhui (ed.) [1998, 1-12]
(2) Zhongyang Caijing Lingdao Xiaozu Bangongshi et.al (eds.) [1999, 1-28]
(3) State Economic and Trade Commission website
(http://www.setc.gov.cn/gjjmwznzn/gyswgh/200206240011.htm)

benefits to retirees who have not accumulated a reserve in the past, during the transition period from the pay-as-you-go system to the fully funded system. The pension liability that occurs in the transition period is estimated by the State Council to be about 3.7 trillion RMB or 40% of the GDP (*Caijing*, No.3/4, February 5, 2002).

In the northeast region, where the society is aging rapidly, the income and expenditure imbalance in the pension fund is already coming to the surface. In 1997, five cities nationwide were with the income and expenditure imbalance, increased to 21 cities by the following year, and a deficit of 5.2 billion RMB occurred in the fund income and expenditures at the national level in the same year. Although the fund was back in the black on the national level by the following year, the income and expenditure imbalance continued to grow on the regional level. In 1999, the region with the imbalance grew to 25 cities, and in the four provinces/cities including Tianjin and Jilin, the funds accumulated in the past had almost all been used up (*Far Eastern Economic Review,* May 30, 2002).

Against the backdrop of these conditions, the government has been expanding social security payments since 1998 (Table 3). The social security payments have been calculated as a national expenditure item since the settlement of accounts in 1998. The social security payments that did not account for more than 1.4% of the entire expenditures in 1998, grew to exceed 5% by 2001. The State Council established a nationwide social security fund (China National Social Security Fund) in 1999 in order to cover the income and expenditure imbalance of the regional funds, and has been contributing about 30 billion RMB annually ever since.

Fiscal deficits have been expanding rapidly due to increase in public investment expenditures for boosting domestic demands in recent years, and they have reached the 250 billion RMB level (Figure 1). In the estimates of the Labor and Social Security Ministry, the current pension system is maintained, and based on the premise of no major changes in the population trend, in the next 30 years an average annual deficit of 100 billion RMB is expected for the pension fund (*Far Eastern Economic Review, same issue*).

Table 3 Glowing Government Expenditure on Social Security

Year	Budget Items Related to Social Security	Budget (100 mil. RMB)	Closing (100 mil. RMB)	Share in Annual Expenditure Total
1998	Social security subsidiaries	0.0	150.0	1.39%
1999	Social security subsidiaries	168.2	343.6	4.73%
	National social security fund	0.0	280.0	
	Total	168.2	623.6	5.20%
2000	Social security subsidiaries	460.0	526.0	
	National social security fund	0.0	300.0	5.21%
	Total	460.0	826.0	
2001	Social security subsidiaries	n.a.	672.0	
	National social security fund	n.a.	310.0	
	Total	n.a.	982.0	

Note: Budget items related to social security did not exist prior to 1998.
Source: Prepared from *Zhongguo Caizheng Nianjian*, various years.

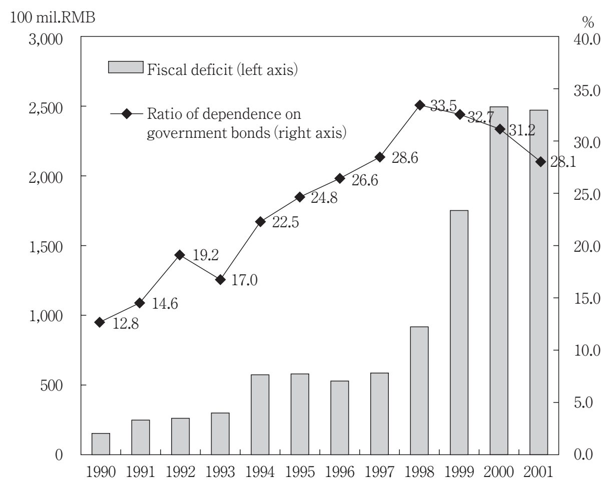
5.1.2 Setbacks for the Policy to Sell State-owned Shares

(1) Start of State-owned Shares Sales

The government decided to adopt the policy of selling state-owned shares in an effort to address the pressing problem of avoiding the risk of a financial crisis. The first trial was at the end of 1999 when the policy was carried out for an initial two listed companies on a limited scale. However, owing mainly to high prices in relation to the sluggish prospects of the companies, investors reacted unenthusiastically and a substantial part of the shares remained unsold. The stock prices fell immediately after the sale, leaving the purchasers bearing a capital loss.

After an reconsideration of a year and a half following the failed first trial, the State Council issued the "Interim Regulations Relating to the Management of Social Security Capital Procurement Using the Release of State-owned Shares" in June 2001, resuming eventually the policy of selling state-owned shares on a full-fledged scale. Under these regulations, when state-owned companies reorganized as joint stock corporations offer shares publicly or increase their capital, they

Figure 1 Glowing Fiscal Deficit



Note: Ratio of dependence on government bonds = income from government bond issues/government income
Source: Based on *China Statistical Yearbook*, various years.

are obligated to sell state-owned shares equal to 10% of the capital procurement amount, and pay all the sales revenues to the National Social Security Fund. In May 2001, just before the announcement was made, the Chinese stock markets reached record highs, and under the plan, revenues of 50 billion RMB could be obtained within the year through the sale of state-owned shares.

Unfortunately, the policy for selling state-owned shares based on the "Interim Regulations" ended in a dramatic failure. Just around the time of the interim regulation announcement, stock prices began to drop suddenly, ending up with a depreciation of over 30% by October. Finally, the government was forced to declare a temporary suspension of the interim measures on October 22. The sales amount was far below estimates at 12.2 billion RMB, the aggregate capitalization of the stock markets shrank by close to 1 trillion RMB from the time of the peak, which resulted in backing up investors fears over the policy of selling state-owned shares.

(2) Change in Policy

The trial sale of state-owned shares that began after full preparations and ended in a setback, made it unavoidable that the government revise its policy fundamentally. In June 2002, the government announced to permanently suspend the related provisions of the interim regulations, except for listings on overseas stock markets, and decided to give up the release of state-owned shares on the domestic stock markets.

The series of events showed that the policy for selling state-owned shares on the stock markets itself was essentially flawed. Shares owned by households are at a comparatively low rate of 6% of household financial assets, offering a lot of potential for growth. However, Chinese stocks are extremely volatile compared to international standards, leaving shareholders with a lot of risk. For this reason, it cannot be expected that households with actively increase their purchase of shares. As long as stock purchases by households, which represent the largest share of financing surplus, do not expand, the sale of state-owned shares through the stock markets will be greatly impeded.

In order to lessen the risk for stock investors, it is necessary to increase the stability of the financial performance of listed companies, which in turn requires significant improvement in corporate governance. This is hard to be achieved as long as the rate of state-owned shares remains high. On the other hand, in order to ease the pressure that covering the pension fund shortage has placed on the state finances, a fixed cash flow needs to be secured from state-owned shares, which exceed 2 trillion RMB measured by the aggregate market value.

As long as the government tries to advance sales of state-owned shares through sales on the stock markets to general investors, it will not be able to escape from this dilemma. It is imperative to seek out investors that have both the intention and the ability to contribute towards improving management efficiency of listed companies.

When the release of state-owned shares was suspended, the State Council announced to investigate, as alternative measures, transferring the state-owned shares needed to cover the pension fund shortage to the national social security fund, and securing cash flow through sales to "strategic investors" or through dividends. Strategic investors as envisaged by the government imply agents such as institutional investors, private companies, and foreign-capital companies. In particular, private companies are already increasing their presence in taking initiatives in the process of privatization through the purchase of listed state-owned companies. In addition to this, there are also an increasing number of cases where privatization is being carried out through the purchase of state-owned shares by employees inside the companies, and managers and management executives in particular. In the next part, we will investigate the limits and possibilities of each of them as agents of privatization.

5.2 Agents in Privatization

5.2.1 Who will Take Initiatives in Privatization?

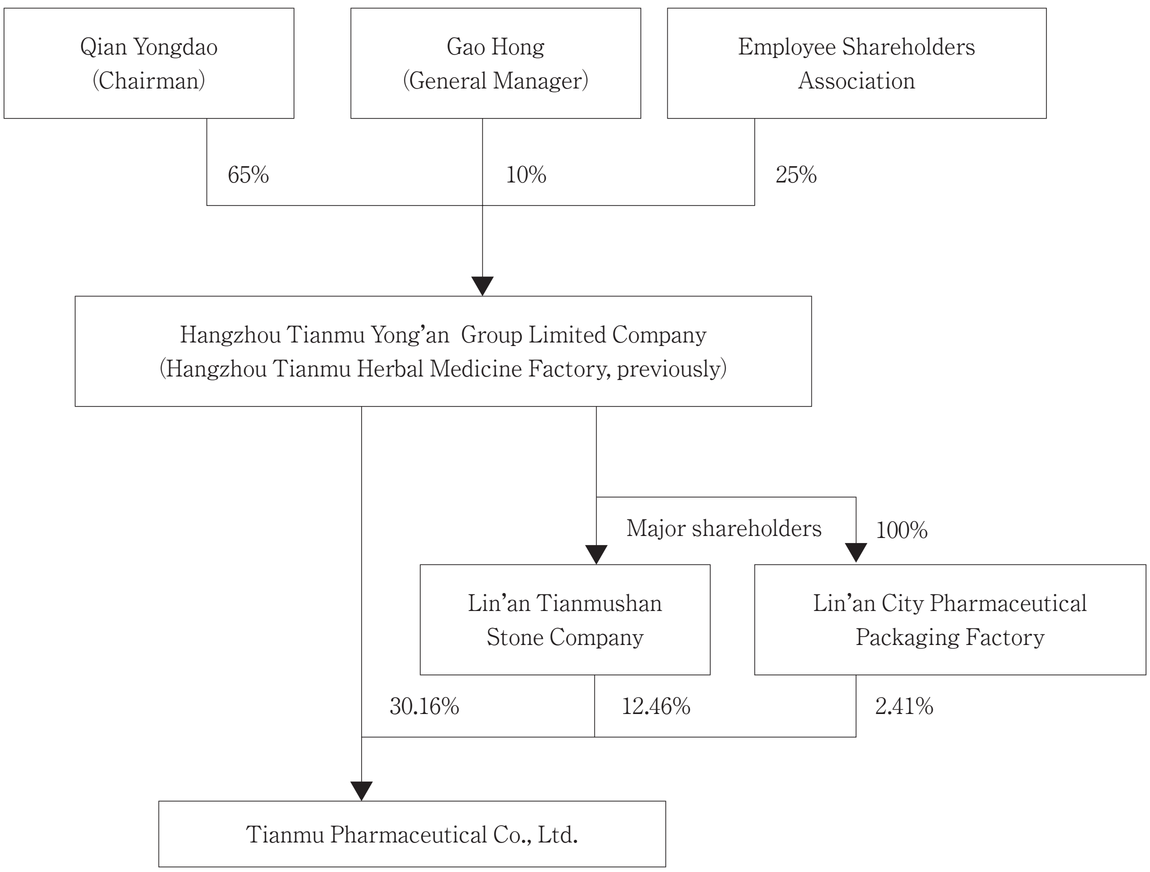
Agents who will take initiatives in the divestiture of state-owned shares should be capable of making contributions to the improvement of corporate governance of companies subject to privatization. The dispersion of shares widely among small-scale general investors is not always desirable from the standpoint of corporate governance since it is likely to lead to a lack of effective monitoring on the management.

5.2.2 Institutional Investors

In recent years the Chinese government has begun attaching greater importance to the development of institutional investors as the agents who are expected to be principal actors in the corporate governance of listed companies. According to the estimates of a senior economist affiliated with the People's Bank of China, 40% of shares in circulation are being held by investment funds if those not officially approved are included. These investment funds are, however, focused on speculative short term buying and selling to date and are far from qualified as agents of sound corporate governance.

Institutional investors such as pension funds and insurance companies are more qualified in this sense since the nature of their funds dictates that they are likely to have

Figure 2 Management-Buyout of Tianmu Pharmaceutical



Source) Compiled by author based on New Fortune, August 2002 issue and securities-related websites.

a perspective oriented towards long-term stable earnings instead of short-term speculative gains with high risks accruing from them. The State Council has set forth a policy of entrusting the management of the national social security fund to fund management companies and is now in the process of selection. The government is also taking measures to introduce foreign capital to the fund management with a view to promoting improvement in the management level of fund management business in China (to be discussed later).

5.2.3 Buyouts by Executives and Employees

In the case of privatization of small and medium companies, management buyouts (MBO) and management-employee buyouts (MEBO) are used widely. Even for companies or listed companies that are comparatively large scale, there are cases of privatization of through MBO or MEBO.[3]

Case 1: Tianmu Pharmaceutical

Let us look at Tianmu Pharmaceutical Co., Ltd. as a model example of a listed company MBO (Figure 2). The parent of Tianmu Pharmaceutical is Hangzhou Tianmushan Pharmaceutical Factory, a state-owned manufacturer of Chinese herbal medicines belonging to Lin'an City, Zhejiang Province. Tianmu Pharmaceutical, with Tianmushan Pharmaceutical Factory as its principal shareholder, had its shares listed on the Shanghai Stock Exchange in 1993. Its total assets are 400 million RMB, and it is a comparatively small company among the listed pharmaceutical companies.

In 2000, the principal shareholder, Tianmushan Pharmaceutical Factory was reorganized as Hangzhou Tianmu Yong'an (Group) Corporation. At the same time, the company ownership was distributed in the form of 65% for Qian Yongtao, the manager, 10% for Gao Hong, a company executive, and 25% for the employee shareholders. In doing this, Tianmu Pharmaceutical turned into a company where the manager is the owner controlling the assets. Qian Yongtao joined Tianmushan Pharmaceutical Factory in 1965, and after becoming General Manager in the mid 1980s, he contributed greatly to development of the company that was no more than a middle-scale local manufacturer. Privatization meant the legal establishment of ownership rights to back up the actual situation where Qian Yongtao had de facto personal management control of the company. The indirect format of buying out the principal shareholding company meant a reduction in the funds needed for the buyout and the avoidance of the sudden changes in investor structure of the listed company.

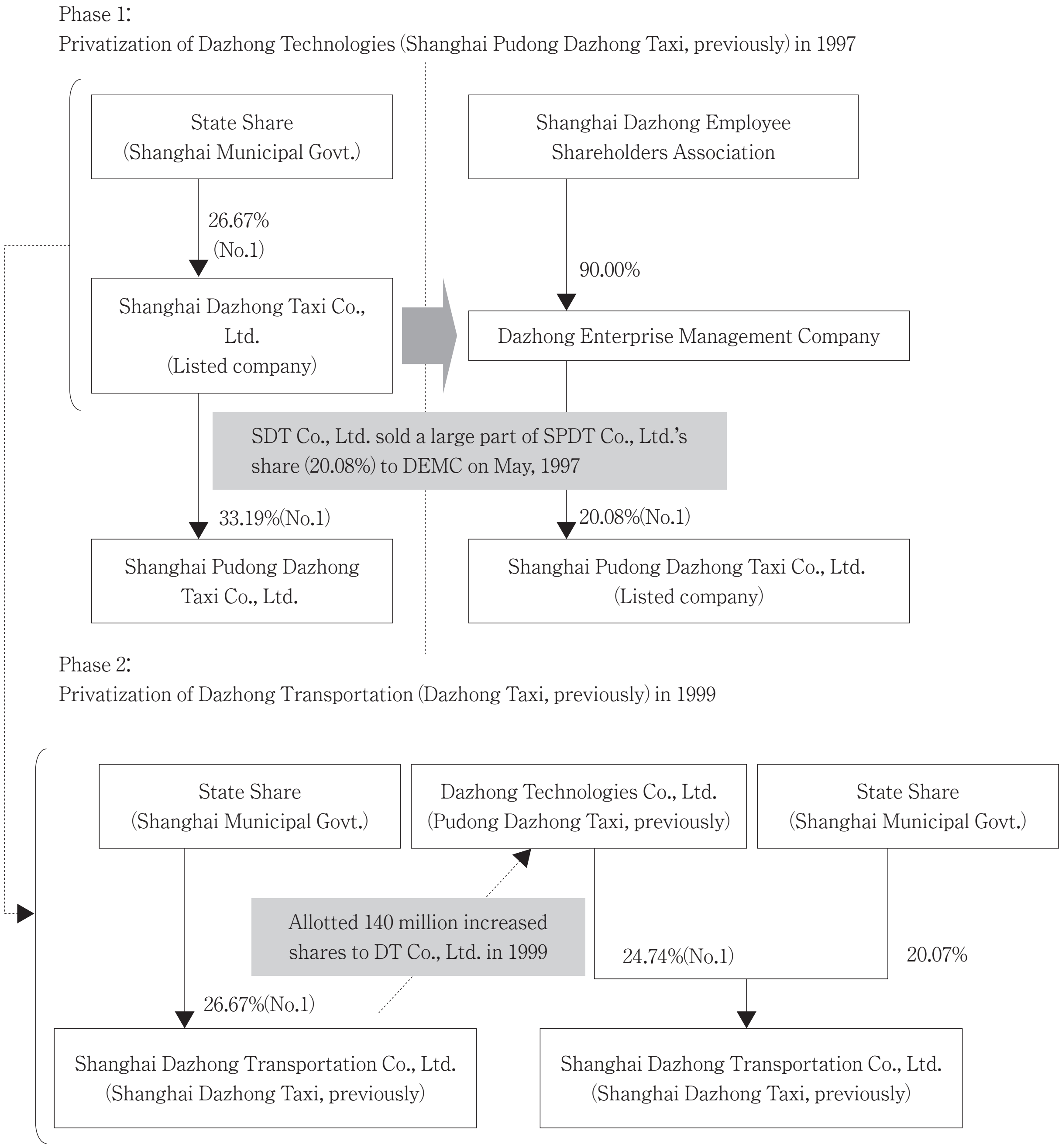
Case 2: Dazhong Transportation & Dazhong Technologies

Instead of an individual manager, there are not a few cases of employees as a group taking initiatives for privatization. A typical example of this type is Shanghai Dazhong Taxi (Figure 3).

Shanghai Dazhong Taxi (Dazhong Taxi, hereafter) reorganized its business in the old city of Shanghai (Puxi district) as Shanghai Dazhong Taxi Co., Ltd (Dazhong Taxi Co., Ltd, hereafter) and listed it in 1992, and at the same time Dazhong Taxi reorganized its business in Pudong district as Pudong Dazhong Taxi Co., Ltd. (hereafter Pudong Taxi Co., Ltd) and listed it with controlling capital held by Dazhong Taxi Co., Ltd.

In view of increasingly severe competition in taxi business in Shanghai, in 1997 both listed companies decided to broadly reorganize their ownership structures. First the employees of both companies made an investment of 70 million RMB to establish the Dazhong employee shareholders association. Under China's current regulations, there are many restrictions on employee shareholder associations carrying out economic activities such as share ownership without the status of

Figure 3 Management-Employee Buyout of Dazhong Transportation and Dazhong Technologies



Source: Compiled by author based on *New Fortune*, August 2002 issue and securities-related websites.

a corporate entity. For this reason, by undertaking a capital increase for Dazhong Enterprise Management Corporation, which was an already existing subsidiary, in the name of the labor union, and taking capital control, and by transferring 20.08% of the 33.19% of Pudong Taxi Co., Ltd.'s shares held by Dazhong Taxi Co., Ltd. in the past to Dazhong Enterprise Management Corporation, indirect capital control by employee of Pudong Taxi Co., Ltd. was realized.

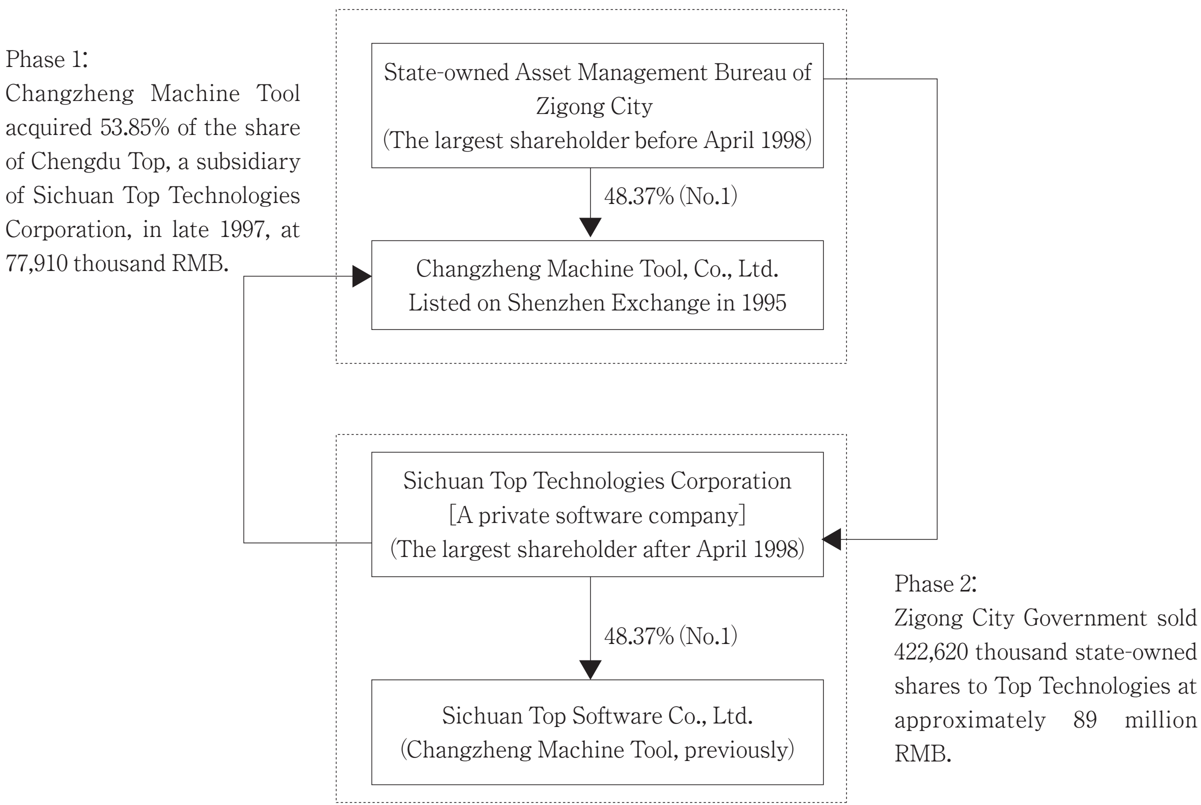
Then in 1999, the name of Dazhong Taxi Co., Ltd. was changed to Dazhong Transportation Co., Ltd., and third party allotment capital increase was carried out with Pudong Taxi Co., Ltd. as the receiving party. In this way, Pudong Taxi Co, Ltd. (renamed Dazhong Technologies Co, Ltd. then) became the principal shareholder with 24.74% of the issued shares of Dazhong Transportation Co., Ltd., and previous principal shareholder, Shanghai municipal government, became the second principal shareholder. In this way, the privatization of the two listed companies, Dazhong Transportation Co., Ltd. and Dazhong Technologies Co, Ltd., was actually accomplished by employee ownership.

In the case of companies with good business results, buyout by management or employees offers substantial advantages from the point of allowing smooth privatization. However, there are also the disadvantages of not being able to expect new capital investment from the outside, and the fact that employee buyout tends to be a hindrance to broad reorganization. Difficulties in raising large amount of capital for the management and the employees dictate that companies suitable for MBO or MEBO privatization would have to be limited to comparatively small or medium companies.[4] In order to promote privatization for a large number of large companies, it is necessary for agents from outside the companies to take initiatives in the process of privatization.

5.2.4 Private Companies

Buyouts of listed companies by private companies have been taking place increasingly frequently since 1997. Although it is difficult to get an accurate picture of the situation as no official data has been compiled on this trend, an estimate based on announcements of transfer of state shares confirms roughly 40 cases of state share purchases of listed state-

Figure 4 Buyout of Changzheng Machine Tool by Top Group



Source: Based on interviews to Top Group executives (September 1999) and related articles.

owned companies by private companies. If purchases of state-owned legal persons' shares are included, the number of cases of private companies buying out listed state-owned enterprises will be in fact much higher than the estimated figure.

In August 2000, the Ministry of Finance, in preparation for the divestiture policy of state-owned shares on the market, suspended new approval of state-owned share transfers to private companies. Permission from the Ministry of Finance resumed in August 2002, and as of September 2002 at least 40 companies have achieved agreements for purchase of state-owned shares by private companies.

A great majority of the buyouts of listed companies by private companies to date has been aimed at obtaining the position of a listed company by private companies, which have had high hurdles to listing. This kind of case is called "shell buying." Recently, nonetheless, there have even been an increasing number of cases of buyout aiming to acquire the business resources of the company to be purchased.

Case 1: Top Group

Purchase of state-owned shares by private companies for the purpose of shell buying has become more common since around 1998. According to a survey by Misheng Securities Research Institute, there were over 65 cases of shell buying by August 2002 (Wangyang Securities Website: http://www.wangyang.com/webdata/data08/0829/0829197.html accessed November 25, 2002). Let us look at the purchase of Changzheng Machine Tool by Top Group, as a representative case (Figure 4).

Changzheng Machine Tool Co., Ltd. was a state-owned machine tool manufacturer that belongs to Zigong City, Sichuan Province. It was listed in 1995, and since then the management has consistently deteriorated, and in 1997 the company was in danger of falling into the red in the next period.

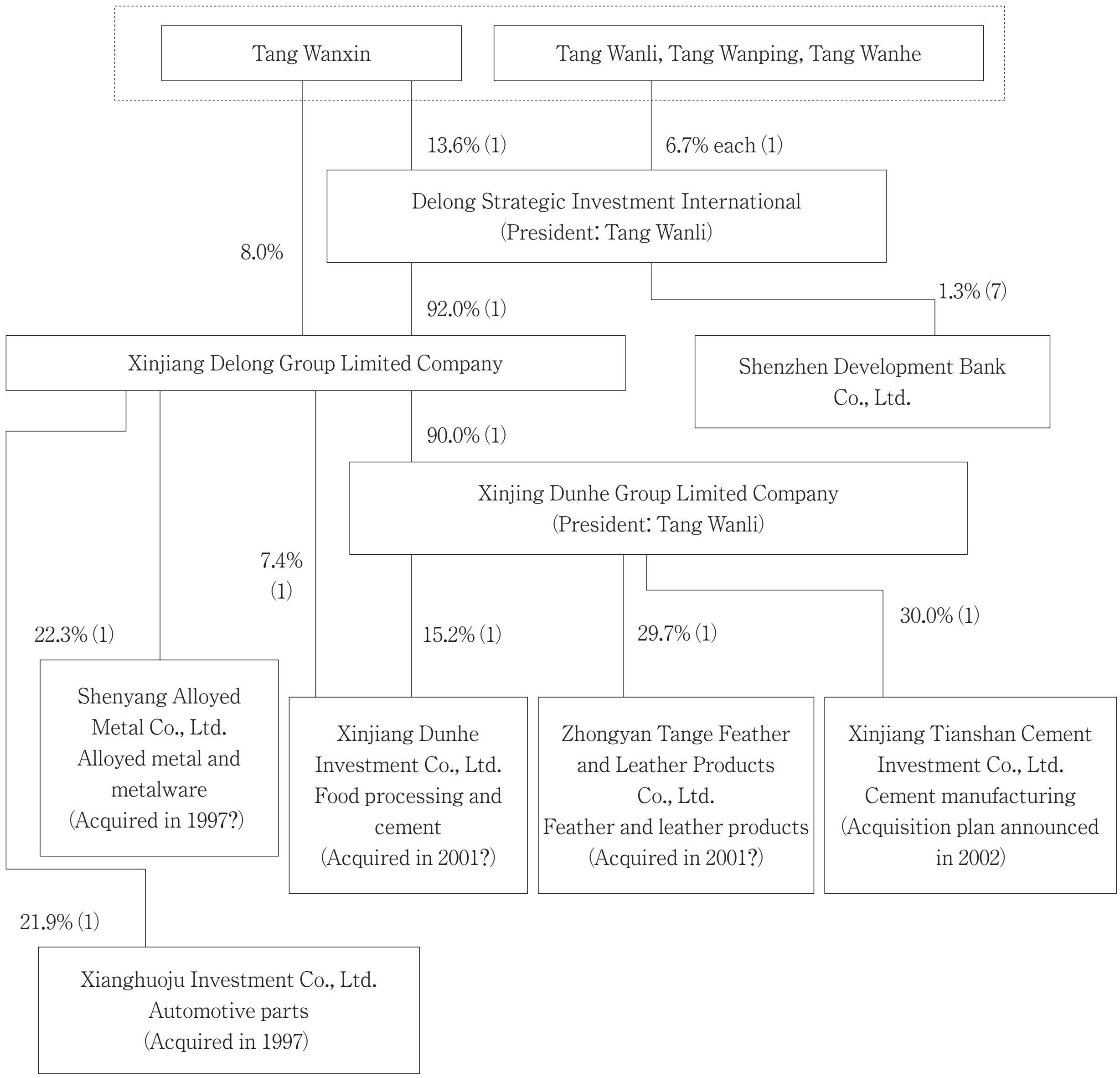
The company that was to become the purchaser, Sichuan Top Technologies Development Corporation, is a private enterprise mainly involved in the computer software business. As a prelude to the buyout, Changzheng Machine Tool purchased 53.85% of the shares of Chengdu Top Technologies Co. Ltd., a subsidiary of Top Group, at the end of 1997. The purchase amount of 77.91 million RMB was financed by the Zigong State Asset Management Bureau. At the same time, Changzheng Machine Tool decided to change its principal business area to computer software.

In April of the following year, the Zigong State Asset Management Bureau agreed to transfer all the state shares of Changzheng Machine Tool to Top Group for 89 million RMB. At the same time, the Zigong State Asset Management Bureau provided Top Group with a loan of 89 million RMB equal to the purchase price, to be repaid in six years. In other words, Top was able to make the purchase without any cash up front. When the income from the sale of the subsidiary company that was a prelude to the buyout is taken into account, the final purchase price was only 10 million RMB.

Through the purchase of state shares, Top became the principal shareholder of Changzheng Machine Tool with 48.37% of its capital. Then in May, the founder of Top, Song Ruhua, became the Chairman of Changzheng Machine Tool, and the company name was changed to Sichuan Top Changzheng Software Co. Ltd. (and afterwards changed to Sichuan Top Software Co. Ltd.). After the purchase was complete, Top Software changed its principal business area to software manufacturing, and the machine tools manufacturing business was scaled down and broadly revised by measures such focusing on the important area of NC machine tools.[5] Currently the machine tools only account for 10% of the company's sales, and 3% of the revenues.

In the case of shell buying, the main purpose of the buyout for the private company is to obtain the status of a listed company,

Figure 5 Ownership Structure of Delong Group (Summary)



Note: 1 Figures in parenthesis denote ranks as shareholders.
2 The time of acquisitions are estimated based on disclosed materials.
Source: Same as Figure 2.

above all else. For this reason, the companies that are the subject of these buyouts are those with deteriorating business results, without exception, and after the purchase the businesses of these companies are completely revamped. In the case of Top Group, the machine tools business was revised and continued, however there are many cases where the original business of the company has been completely eliminated.

Case 2: Delong Group

Next, let us look at the case of the listed company purchase by Delong Group, as an example of a buyout to obtain the business resources of the company being purchased (Figure 5).

Delong Group was established by Tang

Wanxin and his three brothers from Xinjiang, and went on to amass capital in the securities investment business. In 1997 the brothers advocated conversion to manufacturing industries and began preparing in earnest to purchase listed state-owned companies. Currently, the brothers have indirect capital control of four listed companies, through Delong Strategic Investment International, in which they have controlling capital. Including the project still being planned, it would extend to five listed companies in which they have controlling capital, and could be the largest buyout of listed state-owned companies by private capital.

Although the brothers have invested in a diverse range of industries, in recent years Delong Group has been focusing most of its attention on the automobile industry. Xianghuoju Investment Co., Ltd., which the group bought in 1999, has 40% of the domestic spark plug market for automobile engines, and is the number-four company among the domestic automobile parts producers. Delong Group purchased several automobile parts makers through Xianghuoju, and is diversifying the company's products from spark plugs to a wide range of other automobile parts.

Currently, Delong is looking to move into completed automobile manufacturing, and is now planning to arrange a merger with two large state-owned heavy truck manufacturers, Shaangxi Heavy Truck Factory and Chongqing Heavy Truck Factory. Under the current plan, Xianghuoju would provide 51% of the capital for the merger, and the two state-owned companies would provide their production facilities and plants. If the merger were realized, Delong Group would have control of a company with the largest share of the domestic heavy truck market.

The buyout of listed state-owned companies by private companies has become increasingly common, and as Delong case shows, examples are appearing that are linked to the revitalization of the purchased company and industry reorganization. In the future private companies are likely to play the most important role as the agents taking initiatives in privatizing large state-owned enterprises.

The problem is that the management of private companies themselves often lacks stability. The business results of target companies after shell buying generally tend to remain poor and in some cases they deteriorate further. It is pointed out that it is the lack of management ability on the part of the private company that made the buyout less effective in improving performance of target companies (Wangyang Securities Website, as above).

In the case of Top Group mentioned earlier, active investment activities had been carried out including the purchase of two more listed companies even after the buyout of Changzheng Machine Tool. However, profits in recent years have been poor, and the financial situation is deteriorating (*Southern Weekly,* August 29, 2002, http://www.southerncn.com/weekend/economic/200208290006.htm accessed November 26, 2002). In the case of Delong Group, despite advocating a change to manufacturing industries, the company's history of speculative stock investment as its main business makes it less secured whether the company's real intention is to make long-term industrial investment.

5.2.5 Foreign-capital Companies

The Chinese government has taken a cautious stance towards sales of large state-owned enterprises to foreign-capital companies. In 1995, Isuzu Motors and Itochu Corp. purchased the legal-persons' shares of Beijing Light Bus Co., Ltd., a Shanghai-listed automobile manufacturer, and by combining the shares held by the two companies, they were able to become the de facto principal shareholder. This struck a nerve with the central government, which was placing priority on its automobile industry policy at the time, and the State Council issued an official notice prohibiting, in principle, the purchasing of listed company shares by foreign-capital companies. However, as part China's entry into the WTO, China has been asked to stop this kind of discriminatory treatment of foreign-capital companies. The change in policy on selling state-owned shares came with the ease in regulations towards the purchase of state-owned companies by foreign-capital companies. In September 2002, the government set forth a policy of selective approval based on foreign investment guidelines for the purchase of listed company shares by foreign-capital companies.

Shanghai and Shenzhen are the most active in the area of selling large state-owned enterprises to foreign capital companies. Both cities are promoting sales to foreign-capital companies even in the fields where the participation of non state-owned categories has been restricted all along, including the categories of infrastructure and finance. In the infrastructure category, Shanghai Municipal Government sold the Shanghai Waterworks Pudong Company, which is a state-owned water department, to Vivendi, a French conglomerate. In September 2002, Shenzhen announced a policy to sell 25% to 70% of the state-owned shares in five state-owned utility companies, including electric, gas, and water companies, to foreign-capital firms.

In financial sector, the Shanghai Bank already received investment from the Hongkong and Shanghai Banking Co. Ltd. in 1999, and the Shanghai Pudong Development Bank Co. Ltd. is now in consultation with Citibank for that US bank to obtain an 8% to 10% share of the Chinese bank. In these cases, the foreign-capital participation has been limited to financial contributions only. Meanwhile, Shenzhen has already reached an agreement to sell a majority of the state-owned and legal-entity shares of the Shenzhen Development Bank held through a related institution, to the US investment company, Newbridge Capital.[6] If the agreement is realized, it will be the first case of a bank affiliated with a local government being bought out with foreign capital.

The Chinese government is starting to introduce foreign capital into even the investment fund sector. In November 2002, the Regulatory Rules on QFII Securities Investment (QFII: Qualified Foreign Institutional Investors) were introduced, which open the domestic capital market for foreign institutional investors approved by the Chinese authorities.

Conclusion: Prospects for Privatization of Large Companies

With the developments between the 15th and 16th National Congresses of the CPC, the political restrictions on privatization have been basically eliminated. Along with this, the trend towards privatization of large state-owned enterprises has gained momentum. As was examined in this chapter, institutional investors, management executives, private companies, and foreign-capital companies have been emerging as agents that will take initiatives in corporate governance of in place of the government.

However, the Chinese market economy is still at its nascent stage of development. The domestic actors that are expected to push forward with privatization process do not necessarily have sufficient abilities in financing privatization and efficiently managing privatized companies. Private companies, which are already becoming active in the purchase of state-owned listed companies, have their own problems with the lack of their own management stability. The Chinese government has expectations for the participation of foreign-capital firms in privatization, however foreign capitals' participation in China's privatization market will be more selective in terms of profitability and risk.

In the near future, the trend towards privatization will likely be more focused on medium-sized companies under the jurisdiction of local governments. The tide of privatization will reach the largest enterprises under the jurisdiction of the central government in the long term. However, the larger and more complex a company, the greater the degree of difficulty for privatization, and the more time needed for its achievement. The mixed systems of state and private capital existing side by side are likely to continue into the long term.

(Ken-ichi IMAI)

Notes:

1. One more important point relevant to the issue is the change in policy relating to the ownership of state-owned assets. Under the previous principle, the ownership of state-owned assets reverted to the state, and the local governments only exercised management rights. However, in the General Secretary's report from the 16th National Congress of the CPC, it states that "the central and local governments each exercise owners' duties on behalf of the state, and possess ownership rights and interests," relating to the system for state-owned assets. Therefore, the exercising of ownership power over state-owned enterprises that fall under the jurisdiction of the local governments has been recognized, and discretionary rights over the promotion of privatization have been greatly expanded.
2. See Imai (ed.) [2001] for the overall development of state-owned and collective enterprises in China up to 2001
3. See the August and September 2002 issues of *New Fortune* for examples of listed company MBOs and MEBO.
4. When selling state-owned shares to management and/or employees as part of MBO or MEBO, the sale may be made at a huge discount or a transfer completed free of charge with the aim of considering the contribution to the development of the company. However, at the stage before the 16th National Congress of the CPC, the Ministry of Finance, which has jurisdiction over state-owned assets, took the policy of not recognizing, in principle, discounted sales or free transfer of state-owned shares to individuals. This kind of regulation was especially severe for large companies, and because of this a setback was unavoidable in the planning of the MEBO for the major air conditioner company, Chunlan.
5. The original machine tools business was transferred to Zigong Changzheng Machine Tool Corporation established by dividing up the main production functions of the former Changzheng Machine Tool.
6. At the end of September 2002, the Shenzhen Development Bank decided to entrust the actual management rights to the staff dispatched by Newbridge, premised on the purchase (*Caijing*, October 20, 2002 news report). Furthermore, since the foreign investment rate is only 25% or less, the Shenzhen Development Bank is considered to be a domestic bank, and the foreign bank regulations do not apply.

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