Chapter 4

Privatization as Risk-Hedging: Ownership Structure and Corporate Behavior of Electric Appliances Companies

Introduction: How Sound Is the Corporate Governance of Chinese Companies?

How sound is the corporate governance of Chinese listed companies? This is the question that motivates this chapter. Before detailing this, let us touch on the cases of countries other than China. After the Asian Currency Crisis broke out in 1997, the soundness of the corporate governance in practice in the crisis-affected countries has been severely questioned. Behind this development, there exists strong motivation to find out the causes of the crisis itself. There already published a number of researches by European and American academics, who were strongly motivated by the fact that European and American investors were severely harmed by the crisis.

Main finding of these research is that the capital structure of Asian firms, especially that of firms in Southeast Asian countries like Indonesia, is "special."[1] These studies have pointed out that in many listed companies controlled by their founders and their families, these families of owner-managers can "exploit" minority shareholders of listing shares.

However, *The Economist,* in its survey of Asian businesses, asserts that this is not the case with Chinese corporations and that overseas investors investing in China can feel rest assured, because the state-owned corporations in China are completely different from Southeast Asian corporations controlled by ethnic-Chinese entrepreneurs, in the sense that these corporations, "owned by all the people," are free from any possibilities that the founding families would refuse to let go of their managerial rights.[2] But is this really true? The purpose of this chapter is to probe into this question.

The history of state-owned enterprise reform in China - involving changes from the system of people's ownership to the contract responsibility system, the recognition of proprietary rights, and privatization - can also be regarded as the history of changes in institutional arrangements concerning the capital structure of corporations. This paper considers it rather plausible to assume that such changes in institutional arrangements must have affected the performance of corporations by changing their capital structure. The capital structure shows, primarily, the sources from which the company is procuring its funds. But in actuality, the suppliers of capital are given the rights to partake in the decision on how the profits should be distributed, or, particularly in the case of the project's failure, in the decision on who should assume what sort of responsibilities and exercise what sort of decision-making authorities. Through this arrangement, the fund suppliers perform the role of governing the company and its managers.

4.1 Corporate Governance and Business Strategies

Competitiveness of a company can be discussed from a variety of perspectives. It can be assessed not only from the perspective of corporate governance, as will be done here, but also from a number of other perspectives such as those concerning the adequacy of corporate strategy, the quality of managers, and organizational health. The interactions among these various factors can be understand as follows, with reference to the structure of balance sheet.

In order for a company to earn a profit, it must make decisions on investment in plants and facilities, or in intangible assets, and on recruitment and allocation of employees. The final outcome of its managerial and strategic decisions on how to invest and how to allocate its employees is reduced to how the company's whole asset is assorted. And ideally, the assortment is supposed to show itself in the asset side of the balance sheet. The corporate strategy of a company shows how the company tries to secure a profit.

On the other hand, in order to invest in such assets, the company must procure the necessary funds. It is expressed as the capital structure on the procurement side of the balance sheet that disclose from where the company has procured the funds, and what liabilities it owes, and to whom. As pointed out already, the capital structure shows, straightforwardly and primarily, the sources from which a company is procuring its funds, and in what forms, in the form of equity or debt. But each of the securities, i.e., equity or debt, is allocated two types of rights in different ways; namely, the right to receive income in the predetermined form (i.e., the cash-flow right), and the right to make decisions over corporate strategy, investment, or personnel (i.e., the control right). It is in accordance with the combination of these two rights that the behavior of the manager is disciplined. In this sense, the mechanism of corporate governance is embedded in the capital structure or design of securities. And the role of the capital structure, or corporate governance, is to check on whether the corporate strategy as manifested on the balance sheet, or the manager who has adapted that strategy is harming all stakeholders' interests. It is possible to say, in other words, that the capital structure shows not simply who is supplying funds to the company, but also who can govern the behavior of the company or its manager.

Thus, by conceiving that the corporate strategy and corporate governance structure are expressed on the asset side and on the procurement side of its balance sheet, respectively, it is made clear that how the company's behavior should be assessed. Even if the corporate strategy works well, so long as there is something wrong with the relationship among its stakeholders, namely, with its corporate governance, the company will fail. Changhong and Kelon, to be examined below, are the cases in point. It is of course the case that a firm with inadequate corporate strategy will fail to earn a profit, even if its corporate governance looks perfect.

This chapter analyzes from the perspective explained above the following three major household electric appliances firms in China: Sichuan Changhong, a corporate group abridged hereafter as "Changhong," which is headed by Sichuan Changhong Electronic Holding Company and includes Sinchan Changhong Electric Co., Ltd. as a listed company; Guangdong TCL, a corporate group abridged hereafter as "TCL," which is headed by Guangdong TCL Holding Company and includes TCL Communication Equipment Co., Ltd. (abbreviated as TCL Communication), and TCL Holdings International (abbreviated as TCL International) belong to as listed companies; and Guangdong Kelon, a corporate group abridged hereafter as "Kelon," which is headed by Guangdong Kelon (Rongsheng) Holding Company and includes Guangdong Kelon Electric Co., Ltd. as a listed company.[3] Table 1 summarises profiles of the three companies.

4.2 Changhong

Changhong, headquartered in Mianyang City, Sichuan Province, is the largest color TV manufacturer in China. It has developed as a typical state-owned enterprise with close relations with the local government. After growing by leaps and bounds from the late 1980s until the end of the 1990s, the company got stagnated since the beginning of the 2000s.This led to a change in its management. By the end of 2002, there has been no announcement of privatization of the company.[4]

Table 1 Profiles of Changhong, Kelon, and TCL

	Changhong	Kelon	TCL
Establishment year	1958	1984	1980
Original name	No 780 Factory of The Fourth Ministry of Machinery. Renamed as State-owned Changhong Machinery Factory, later.	Shunde Zhujiang Refrigerator Factory	Huiyang District Electronics Industry Corporation
Original ownership status	State-owned	Township enterprise	State-owned
Supervisory body or representative of government share	At the point of establishment: The Fourth Ministry of Machinery. 1985: Sichuan Provincial Government 1987: Mianyang Municipal Government	Rongqi Township Government in Shunde (later Ronggui Township)	At the point of establishment: Bureau of Machinery Industry of Huiyang District Government Later: Huizhou IndustrialBureau
Ownership reform	Issued and listed A share in 1993. Ownership reconfirmed. State-share accounted for 80 % of the total then, which declined gradually later.	Township Government sold 20 % of its share out of 34% to a private company.	After issuing A share in 1994, diversified into several ownership-type companies like wholly-state-owned, joint venture, stock listing company, etc. Authorized as a "management body of state-owned assets" in 1997. Employee ownership was confirmed at the same time.
Name of group corporation and its major shareholders	· Sichuan Changhong Electronic Holding Company · Wholly state-owned. Controlled by Sichuan Provincial Government or Mianyang Municipal Government.	· Guangdong Kelon (Rongsheng) Holding Company · Wholly owned by Township Government.	· TCL Holding Company · Huizhou City Government: 40.97% Employees: 25%[1)] (Li Dongsheng: 7.3%; Yuan Xincheng: 1.39%[1)])
Listed company	Sichuan Changhong Electric Co., Ltd (A share listed on Shanghai Stock Exchange)	Guangdong Kelon Electric Co.,Ltd(A share listed on Shenzhen Stock Exchange and H share)	TCL Communication Equipment Corporation (A share listend on Shen-zhen Stock Exchange) TCL Holdings International
Consolidated financial performance of the group	Sales: 13 billion RMB; Profit: 1 billion RMB (1999)	Sales: 8.17 billion RMB (1999)	Sales: 20.6 billion RMB(TV sets: 11.8 billion; Telecom equipment:1.2billion; IT equipment 2.2 billion; Light electric appliances: 0.3 billion (2000)

Source: *China Yearbook of Electronics Industries*, various issues, and annual reports of the relevant companies.
Note 1 : See Figure 3.

4.2.1 Changhong, the Hero of Local Manufacturers

Throughout the 1990s, Changhong was the hero of China's local electric appliances manufacturers. In August 1989, Changhong became a "rebel" by launching a policy for bargain sale of its TVs in defiance of the regulated price. This action ignited what is known as the First TV Price War. The government, in its effort to arrest the inflationary trend, had introduced in the preceding year a 900-RMB consumption tax on TV sets. However, TVs were much in demand by ordinary people who were earning increasingly greater incomes and were eager to upgrade their living conditions. With a view to meeting this popular aspiration, Changhong defied the regulated price imposed by the central government, and reduced the price of a TV set by 350 RMB. Changhong was appreciated as "a friend of ordinary people," and the "hero of local firms". It should be noted, however, it is said that when Changhong launched this price-cutting policy, it was desperately running short of fund, having only a little over 1,000 RMB cash in hand, while saddled with a huge inventory of 200,000 TV sets worth 320 million RMB. Unable to borrow the operating fund from banks, it is said that the company have taken recourse to price reduction as the last resort to obtain what little cash it might be able to. Given the fact that not only Changhong, but also other TV manufacturers across the country were having huge inventories, the government had no choice but to tacitly approve Changhong's price reduction.[5]

One factor that made it possible for Changhong to facilitate the drastic price reduction in response to the market condition was the fact that the company had been rapidly expanding its productive capacity. Changhong became the industry leader in terms of productive capacity, by boosting its annual TV manufacturing capacity to the one million mark in 1988 for the first time as a Chinese electric appliances manufacturer, and then actually turning out one million TV sets in 1990. The expansion of the productive capacity was undertaken in response to the market condition of the time, where TV sets were absolutely short in supply.

4.2.2 Piled-up Inventries and Resignation of CEO Ni Runfeng

However, the great leap forward by Changhong came to a standstill in the latter half of the 1990s, as the market for TVs which had been characterized by an excess demand was now hit by a glut. As shown in Table 1, the industry's productive capacity in 1995 became almost twice the sales volume, and in the face of this change in the market condition each TV manufacturer was forced to change its corporate strategy.

Despite the drastically changed market condition, Changhong failed to work out a clear-cut sales strategy promptly enough. While TCL, in its quest to gain a competitive edge in marketing, as will be pointed out later, began to organize its own network of wholesalers as early as 1991, it was not until 1996 that Changhong tied up with Henan Zhengzhou Stationary and Department Store (abridged hereafter as Zheng-Bai-Wen), an emerging distribution company. Zheng-Bai-Wen adopted a strategy of doing business by means of a "wholesaler's check-and-invoice system," whereby it purchased Changhong's products by drawing bills underwritten by the Zhengzhou Branch of the China Construction Bank, and the products were delivered directly from Changhong to individual retail stores, with the wholesalers concerned issuing the invoices to the retail stores. Zheng-Bai-Wen's strategy was aimed at building a stable "triangle of credit" among itself, its wholesalers, and retail stores, and at increasing price competitiveness by taking advantage of the economy of scale presented by Changhong's productive capacity. Through this alliance, Zheng-Bai-Wen and Changhong became deeply committed to each other to such an extent that in

1997 Zheng-Bai-Wen purchased the TVs manufactured by five of Changhong's TV production lines, which accounted for 30% of the company's total TV production at the time. After concluding the tie-up deal, Changhong continued to expand its productive capacity, which is reported to have reached a 12 million sets-a-year level in 1997. Changhong seems to have left the marketing activities totally to Zheng-Bai-Wen, and concentrating its own managerial resources into expansion of productive capacity.

However, this strategy failed. In 1998 Zheng-Bai-Wen's performance took a turn for the worse, and finally became insolvent in 1999, leaving Changhong saddled with a huge stockpile of TVs and faced with an escalating cash crunch. At the end of 1998, Zheng-Bai-Wen's sales had decreased by 56%, and Changhong and Construction Bank, surprised by the unsound performance terminated their dealings with Zheng-Bai-Wen in a flurry. According to the annual report of Sichuan Changhong Electric Co., Ltd., a listed company, of the account receivable that stood at a little more than 6 billion RMB at the beginning of 1998, the amount receivable from Zheng-Bai-Wen was 1.7 billion RMB, but the latter amount was reduced to 700 million RMB by the end of the year. In contrast, Changhong's own inventories doubled from 350 billion RMB at the beginning of 1998 to 700 billion RMB at the year's end. Changhong's cash flow during the year registered a net outflow of 13,621 million RMB (according to Sichuan Changhong Electric Co.'s annual report for 1998). This means that the company was facing an extremely serious liquidity crisis, because this amount was in excess of the company's operating income, or a little less than its liquid assets in the same year. President Ni Runfeng of Changhong resigned his post in June 2000, most likely from a sense of responsibility for the serious deterioration in Changhong's performance.[6]

4.2.3 Contract Responsibility System Period

The history of Changhong's growth can be broadly classitied into two periods: the "period of growth with the market expansion," which lasted from the latter half of the 1980s to the early half of the 1990s, when the policy of aggressive expansion of the company's productive capacity helped its rapid growth; and the subsequent "period of expansion out of tune with changes in the market condition," the period since the latter half of the 1990s, when the company continued to expand its productive capacity even after the market became glutted with TVs.

Why did Changhong continue expanding its productive capacity persistently? In particular, why did they keep an "excess investment" even after the market was flooded with an excess supply of TVs since the mid-1990s? There must have been a number of factors. But When focusing on excess investment, it is possible to claim that there must have been something wrong with corporate governance concerning the decision-making on investment. This leads to a question as to how the company's financial structure, with its binding effect on the way in which corporate governance was carried out, was constituted, or as to what decisions were made by the stakeholders who were involved in corporate governance.

Let us sum up the changes that Changhong's financial structure went through. In the period until the mid-1980s, when China was under a planned economy, a two-piece set of an investment opportunity and the necessary capital fund was allocated to each state-owned enterprises. Given this state, the very concept of corporate governance in the sense of properly guiding a corporation's investment behavior was non-existent. Subsequently, a distinction among a corporation's funds on hand, its internally generated funds, and its externally procured funds were vague.

And the contract responsibility system,

which was introduced in 1987, might be characterized as a system of quasi debt contract.[7] In the same year, Changhong, as part of recovering its corporate autonomy, made a contract with Mianyang Municipal Government, who were the representative of its owners. The contract required to pay part of its profits to the municipal government. Under this contract responsibility arrangement the government as the supplier of the invest, the corporation or its management pledged to pay a fixed amount of its profit to the investing government, and thereby to distribute its surplus profit. This arrangement is different from an ordinary contract between a corporation and its shareholders. Under the latter contract, ordinary shareholders are provided with the decision-making power, such as the voting power and the power to appoint and dismiss the manager, as well as the right to share in the company's profits in the form of a dividend, provided that the company's operation proves profitable. (The dividend is an income the size of which is not fixed in advance.) However, under the contract deal between Changhong and the Mianyang Municipal Government, the government was alloted not only with the " cash flow right," in the form to receive a predetermined income stream from the profit on a continuous basis, but also with the "decision-making right," such as to appoint and dismiss the manager, and was thus capable of dismissing the manager when the company failed to perform well. The contract deal between Changhong and Mianyang Municipal Government was rather similar to a contract of debt, because of the ways in which the right to cash flow and the decision-making power were defined. An ordinary contract of debt would provide the company or its manager with the right to dispose of surplus profits, if any, on the one hand, while setting the size of cash flow at a fixed level. Fixing the amount of cash flow at a certain level would have the effect of reducing the amount of free cash flow as a source of investment fund available for the manager, and thus preventing the manager from making an excess investment.[8] It is probable that the contract deal between Changhong and Mianyang Municipal Government was performing a function similar to a "quasi debt." If this was actually the case, we can say that the contract responsibility system was functioning a role of preventing inefficient investment.

On the other hand, Changhong was able to make large investments in the period from 1987 to 1993 because the contract deal in 1987 made it possible for the company to retain a portion of its internally generated funds. There is an episode about the contract deal. In 1998, the second year since the contract responsibility system went into effect, Changhong earned a profit totaling 197 million RMB. According to the terms of the contract deal specified at the beginning of the year, 40 million RMB of this amount was supposed to be paid to the government, and the remaining 157 million RMB would have become the company's retained profit. However, the municipal government's financial bureau insisted that "the government should take a large share of the profit, the corporation a medium share, and employees a small share" as dictated by the central government policy in effect at the time, and that the terms of the contract deal should be revised so that 157 million RMB would be paid to the government, and 40 million RMB would be retained by the company. Changhong flatly turned down the financial bureau's demand on the grounds that the contract was legally binding, and could not be changed arbitrarily. Ultimately the settlement of the matter was left in the care of the Party Committee of Mianyang and Mianyang Municipal Government. The party committee and the municipal government found the contract deal effective, and ruled the matter in favor of Changhong. Furthermore, the municipal government concluded a long-term contract which set the standard annual payment to the government at 40 million RMB for the first year, to be raised by the fixed rate of 7.2% a year for a total of 7 years. The signing of this new contract deal allowed Changhong to secure a retained profit on a stable basis, and to expand its productive capacity.[9]

In the period from 1987, the year when the contract responsibility system was launched, until 1993, Changhong expanded its production capacity above one million TV sets a year, and its output jumped from 423,000 sets to 1,593,000 sets. In retrospect, and given especially the subsequent rapid expansion of the market for TV sets, the steps Changhong took to expand its capacity by the margin mentioned above were justifiable as rational behavior. And one can conclude that, in the sense that the contract deal enabled the company to secure a stable flow of retained profits, which in turn prevented it from failing to take advantage of most, if not all, of the precious investment opportunities, the contract deal had the effect of preventing under-investment at the least.

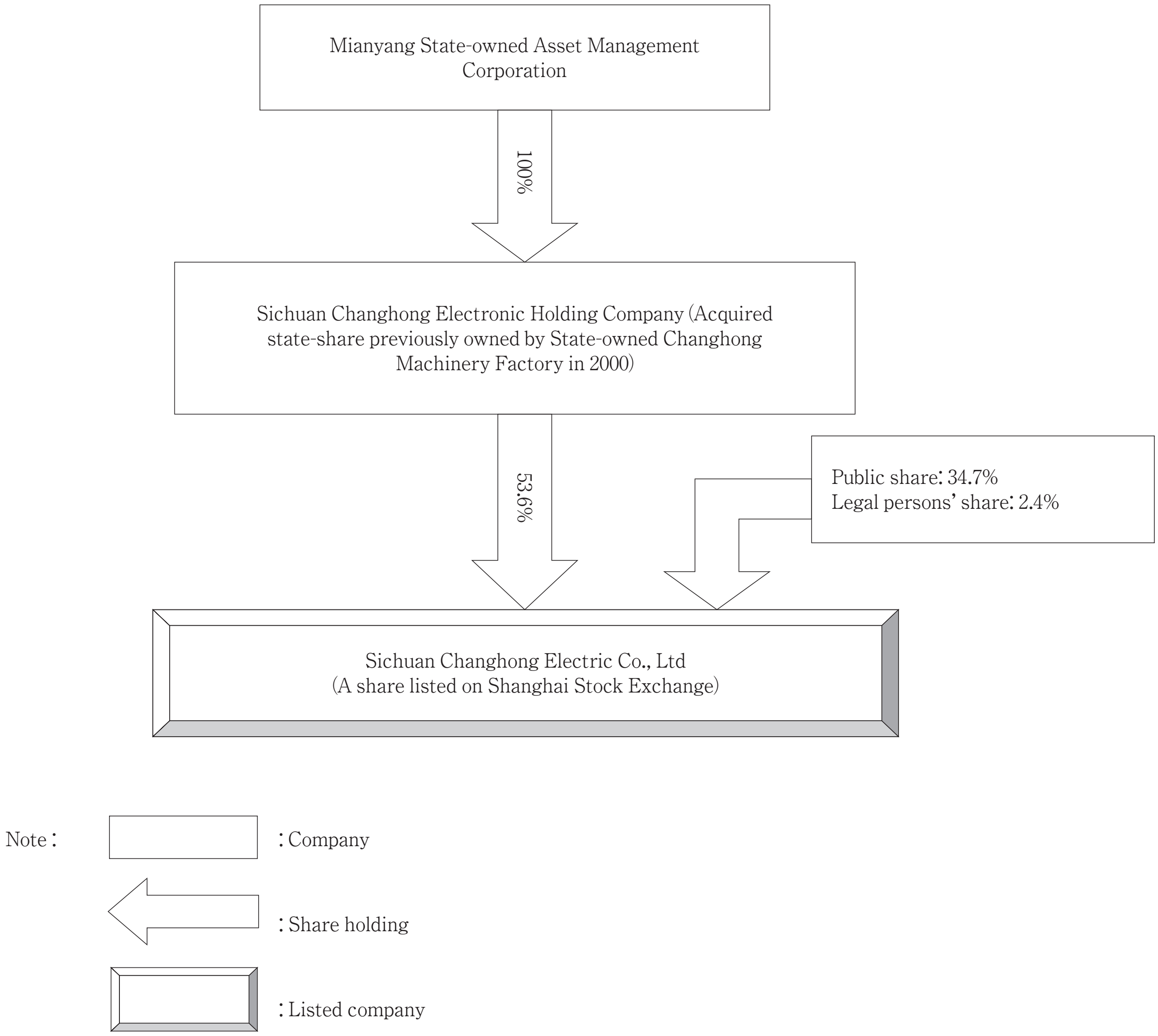
4.2.4 After the Listing Its Shares

Following the listing of its shares in 1994, however, Changhong's corporate governance structure underwent significant changes, so significant as to produce the impression that the proper agents of corporate governance had disappeared. Consequent upon the listing of Changhong's shares, the role of the government changed from that of a quasi creditor to that of an ordinary shareholder. As a result, the "subject" who would play "the role of a debtor" disappeared first. The financial structure of the listed company shows that the ratio of total liabilities to net worth is low, and, moreover, most of the liabilities take the form of trade credits such as accounts payable and promissory notes payable. This means that, whereas previously debts, and in particular borrowings from banks used to invest the creditors with the power of governance, this channel of governance by creditors was now shut down, too. On the other hand, a glance at the composition of shareholders reveals that the holding company which represents the "state share", is the largest shareholder, controlling a dominant portion of the company's shares (Figure 1). Now, if one looks at the capital structure, which is heavily concentrated in the largest shareholder and that creditors are thinly diffused and the amount of liabilities is extremely small, it becomes clear that only the holding company, which is the largest shareholder of Changhong, and the government behind it, have large enough voices to control the behavior of Changhong.

Well, there would have been nothing wrong with this state so long as the government's intention was in line with the goal of maximizing the corporate value. At Changhong, however, some developments took place whereby the government's motivation seems to have either detracted from the corporate value, or worked against the minority shareholders' interests. Of these, the former problem, namely, the problem concerning a loss in the corporate value that could result from the major shareholder's behavior was related to the question of how President Ni Runfeng was treated. Under a heavy concentration of ownership, the largest shareholder is endowed with the power to appoint and dismiss the manager on the basis of his evaluation as to whether the latter is acting in line with the objective of maximizing the corporate value. This arrangement will be free from trouble when the largest shareholder himself is working to maximize the corporate value. In the case of Changhong, however, the largest shareholder was the government, and its decision from its motive as the government injured the corporate value.

As pointed out already, Ni Runfeng, the restorer of Changhong, resigned the post of President, presumably being blamed for the failure of the tie-up with Zheng-Bai-Wen, and for the expanding stockpile and the deterirating cash flow that resulted from the failed tie-up. It may be said that the decision to let Ni

Figure 1 Ownership Structure of Sichuan Changhong Electric Co., Ltd (as of 2000 yearend)



Source : Compiled by the author.

Runfeng resign was in accordance with the principle of maximizing the corporate value. Subsequently, the young successor to Ni Runfeng, named Zhao Yong, who was born in the 1960s, went about adjusting production and reducing the inventory. These measures were quite proper for dealing with the crunch in liquidity that was caused by the expanded inventory. Nonetheless, the inventory adjustment fell into disgrace with the largest shareholder, namely, Sichuan Provincial Government, or Mianyang Municipal Government. It is said that government bureaucrats were outraged because Changhong's decision to slow production in order to adjust its inventory pushed down the gross industrial output of Sichuan Province, thereby hurting the bureaucrats' records of performance. And in April 2001, Ni Runfeng returned in his former post of President all of a sudden, and Zhao Yong was transferred to a bureaucratic post in Mianyang Municipal Government. It is reported that Changhong, immediately following Ni Runfeng's comeback, cornered a huge quantity of cathode-ray tubes and began to pursue expanding production once again. Given the declining prices of TV sets, and the glut of production capacity, such an action seems to bring about an inefficient investment and a fall in the corporate value. As a matter of fact, the company's operation is predicted to fall into the red in 2001 (according to the official announcement of January 25, 2001).

Now, let us turn to the second problem mentioned above, namely the problem concerning the possibility that the largest shareholder will behave in ways harmful to the interests of minority shareholders or outside shareholders in order to safeguard his own interests. When Changhong was undergoing a business slowdown in 1998, it took advantage of the information asymmetry, procuring external funds by issuing new shares, on the one hand, while extending an enormously large credit to the holding company, its largest shareholder, on the other.[10] In other words, a large amount of fund procured from without the company was passed onto the company's largest shareholder. As a result of this manipulation undertaken amidst the business slowdown in 1998, the total assets per share decreased by a large margin, but apparently the largest shareholder alone was compensated for this loss.[11]

The government's serving as the largest shareholder of a corporation is open to question on several counts. To begin with, the government's objective can possibly contradict with the objective of maximizing the corporate value. A second problem, that tends to present itself in a situation where corporation's shares are heavily concentrated in the government as its largest shareholder, is the possibility that the government, in its capacity as the largest shareholder, will try to safeguard its own interests at the cost of minority shareholders' and outside shareholders' interests. In order to avoid these problems, it is necessary to reduce the government's commitment in corporations. In circumstances where the government's motive as the shareholder and its own motive at odds with each other, as in the first case above, it is imperative to let the government completely shed its role as a shareholder, that is to say, let the corporation go private.

As of February 2001, however, no report has yet been made by the press about any move being made at Changhong toward its privatization.

4.3 Kelon

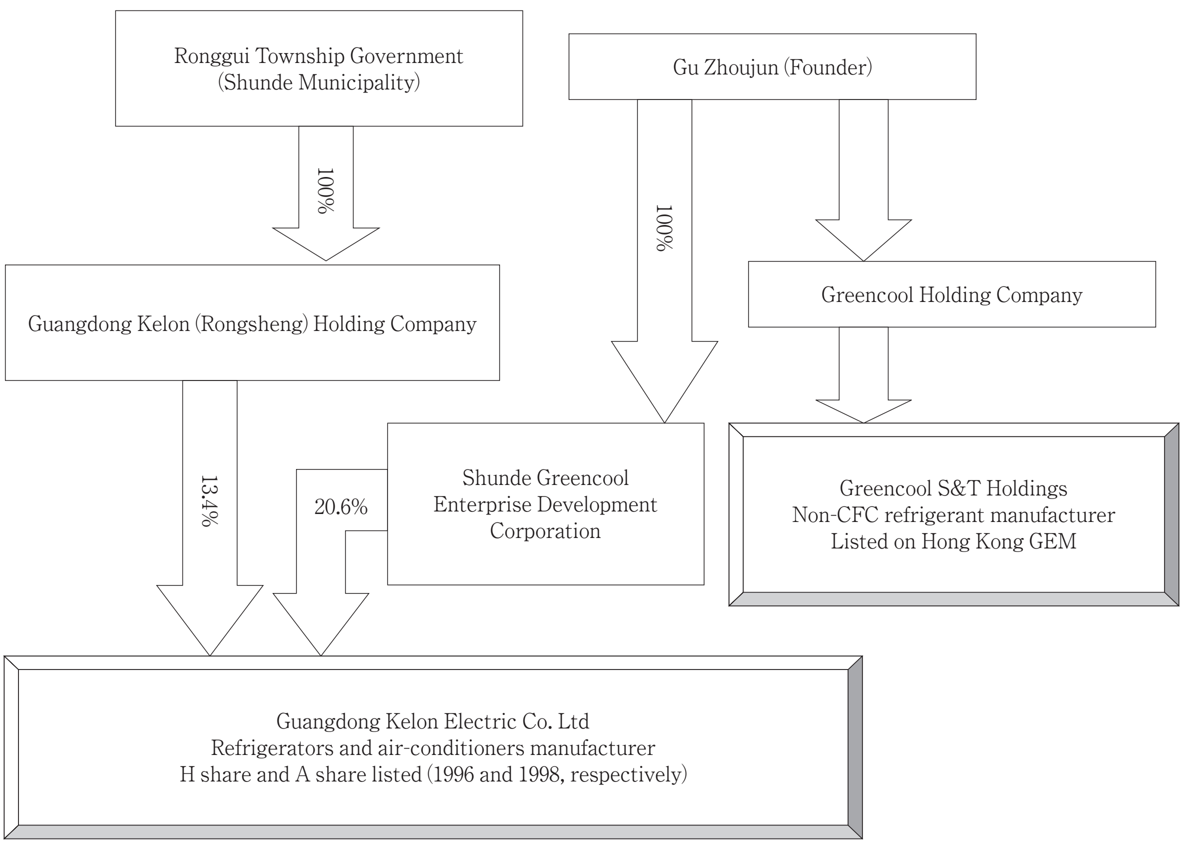
The situation has been much the same at Kelon, the leading manufacturer refrigerators, there was a series of reshufflings of top managers since 1998, and the company's operation remained unstable. Finally in November 2001, a decision was made that the government's shares in the company would be soldout, then the company was privatized while its operation has been yet to be stabilized remained unstable.

4.3.1 From Pan Ning, the Founder to Wang Guorui

Headquartered in Yonggui Township, Shunde City, Guangdong Province, Kelon is a household electric appliances manufacturer good at manufacturing products equipped with heat exchangers, such as refrigerators and air conditioners. Especially in the field of refrigerators, it boasts of a large market share, and is competing for the top position with Haier of Shandon Province. In 1984, the founder of Kelon, Pan Ning, then an official at the Bureau of Machinery Industry of the Rongqi Township Government of Shunde, and several of his colleagues and friends established a company that became the predecessor of Kelon. Since Deng Xiaoping's visit to the company in January 1992 on his Southern Tour Lecture, when he gave there an important lecture of about 40 minutes at the company, Kelon has been regarded as a representative of village and township enterprises.

Kelon has laid the foundation for its development by their investment decisions it made amidst a sharp drop in demand that was triggered by the Tian'anmen Incident of 1989.[12] In the latter half of the 1980s there was a rush of new household electric appliances companies entering the market at such a rate that it was apprehended that there would be an oversupply. And after the Tian'anmen Incident, the operations of a large number of village and township enterprises in the electric appliances industry became stagnant, and many of the refrigerator manufacturers rushed to scale down their production lines. In the face of this apparently gloomy state of things, however, Pan Ning asserted that the existing production capacity was much smaller than the huge potential demand that still remained untapped in China, and, accordingly, Kelon went against the trend, continuing to expand its production capacity. And in the period of economic recovery and expansion that began immediately after Deng Xiaoping's Southern Tour Lecture of January 1992, Kelon's investment decision bore fruit. Taking full advantage of economy of scale, Kelon maintained the largest share in the domestic market for refrigerators for 10 consecutive years from 1990 to 1999.[13] Kelon also adopted a marketing strategy so as to properly cater to varying consumer tastes in different areas. For instance, by selling products of the "Rongsheng" label in the rural area where the consumers show relatively stable preferences for brand-names, while selling products of

Figure 2 Ownership Structure of Kelon (after the privatization in November 1, 2001)



Note: Same as Figure 1.
Source: Compiled by the author.

the Kelon label in urban areas along the seacoast where up-market products and frequent model-changes are much in demand. Kelon's strategy to sell products of different labels in different areas is said to have been also instrumental in sustaining the company's expansion when it was under Pan Ning's reign.[14]

Kelon has been procuring its funds in the following ways. In 1984, Pan Ning and other co-founders together laid out 4.5 million RMB and established a township company under the auspice of Rongqi Township Government. Subsequently in 1992, Kelon increased its capital by 80 million RMB by allotting the new shares to its employees, and then proceeded onto establishing Kelon Electric Co., Ltd. In listing Kelon Electric's stock on the market, Kelon chose to do so on the Hong Kong market in 1996, not on the stock market within China. Kelon Electric's stock was thus listed as an "H share," which was received considerably warmly in the exchange and financial markets of Hong Kong, earning a reputation as the representative bluechip stock of China. When the H share was issued, it was strongly supported by leading financial institutions of the West, with the result that constituting the list of the main subscribers to the H share are such financial firms as Citibank (with a 6.16% share of the stock as of the end of May 1999), Standard Chartered (12.31%), Hong Kong Shanghai Bank (HSBC; 12.04%), and Chase Manhattan (10.19%). Citibank is even dispatching a non-executive director of Kelon Electric. It is worth noting, moreover, that at the time of the Asian Currency Crisis of 1997, when all the other H shares took sharp downturns and fell below their issue values, the price of Kelon's H share alone remained above its issue value. This was partly because of impressions that were formed about Kelon: its status as a village or township enterprise imaged that it would not be strongly influenced by the government; and its pro-active attitude in moving some of its corporate functions to Hong Kong, and in improving communications with investors helped to form an image of Kelon as "a corporation being managed in the way present-day corporations should be," and as "a corporation in which the financial people leads" (setting aside what this really means).

Meanwhile in the refrigerator market, and almost concurrently with the floating of Kelon's H share in 1996, products of foreign labels began to make inroads into China. As products bearing Japanese brand names such as Matsushita (National) and Sharp, and those bearing the American label of Whirlpool began to make inroads into China, Kelon was forced to fight an uphill battle. The position of Kelon was made all the more difficult by the fact that, even though it had expanded its productive capacity by establishing new production bases in Chengdu and Yingkou, it failed to reinforce its marketing capability to match well with this. Thus, Kelon, just like Changhong, was faced with the problem of imbalance between its productive and marketing capacities. In its effort to overcome this problem, Kelon tried to adapt itself to the changed market situation by switching from the old marketing practices based on sales talks at drinking parties or on intimate personal relations to more rational and businesslike practices. When the process of transition was under way, however, Pan Ning witnessed that the marketing teams using the conventional marketing methods outperformed the newly formed teams with their more rational marketing methods; he reached a conclusion that he should resign by all means, so as to help accelerate the process of remodeling Kelon into a rational corporate organization.[15]

In line with this decision, Pan Ning, the founder of Kelon, resigned his post of the Holding Company President on the eve of the listing of the A share in 1998, and then also his post of the Holding Company's Chairman at the beginning of 1999. Chinese corporations that began to develop after China launched its policy of reform and openness are generally "short-lived," and it is also very rare for managers who achieved success to step down to make way for younger successors. Thus, the "retirement of Kelon's founder" set a precedent for other companies. When Pan Ning stepped down, Wang Guorui, who had served as his right-hand man for 14 years since the company's foundation, succeeded to him. Upon assuming the office, Wang Guorui announced that for the time being he would strive to work on the half of Pan Ning's 10-year plan that remained to be completed, namely, the buyout of Huabao, and the full-fledged listing of the A share.[16]

4.3.2 The Negotiation about Merger and Its Aftermath

In the latter half of the 1990s, the domestic economy of China as a whole changed from a state of undersupply to that of oversupply, and companies that failed to adapt themselves to this changed economic climate were performing poorly. By around 1997, Huabao, which was manufacturing air conditioners in Shunde, and Midea, which had began to change its product line-up, which used to be centered around small-sized household electric appliances like electric fans and water heaters, into one centered around air conditioners, were faced with this problem. At that juncture, Shunde Municipal Government mapped out a plan to let Huabao and Midea merge with Kelon, and to establish an all-embracing household electric appliances manufacturer whose product line-up would encompass a whole spectrum of white goods, ranging from large-sized goods all the way down to small-sized ones. Midea turned down the plan, fiercely resisting it, and started to carry out a thoroughgoing reform plan, which included the adoption of a profit center approach.

Consequently, in August 1998, Kelon ended up absorbing only Huabao, and boosting its air-conditioner-manufacturing capacity to 1.5 million units a year, the largest in China at the time. But this merger brought Kelon's deficient marketing capability into sharper focus. At the time of the merger, Kelon had already started manufacturing air conditioners, marketing them under its own label. Products of the Huabao label also held a certain share of the market. So it was decided that the two labels should remain in use side by side with each other. But in the absence of a clear-cut demarcation line defining the territory of each label, the marketing operation was thrown into confusion, and the company's marketing agents and dealers fell into the deficit.[17] This bred a vicious circle by making the distributors distrustful of Kelon, which in turn adversely affected Kelon's own sales performance as well as its earnings, which in turn acted as one of the factors that destabilized Kelon's operation.

4.3.3 Shunde Municipal Government

Located in part of Guangdong Province that has traditionally been characterized as a commercial area, Shunde City is noted for its atmosphere oriented toward market economy. At the same time, however, the city has also lived under a strong influence of planned economy. Officials of the city recollect (in an interview) that following the national government's adoption of the policy of reform and openness, "the city tried to stir up the local economy by making use of the advantages of planned economy." When a contract responsibility system concerning taxation was introduced, the city established a principle for the distribution of its tax revenue: one third of the fiscal revenue would be paid to superior authorities, one third would be retained for the city's own use, and the remaining one third would be invested in corporations (in the form of tax exemption and other expenses). In other words, the municipal government created a setup whereby "the government would become involved in the running of corporations" by actively allocating resources to corporations.[18] Kelon developed from a village and township enterprise, which was established in Rongqi Township of Shunde City as a spin-off from the township government's bureau of machinery industry, as pointed out already. In the course of its development, it received favorable treatment from the township government in the form of tax exemptions and funding for investment. It may be pointed out that Shunde Municipal Government's financial and other contributions to corporations within the city seem to have led it to feel entitled to commit itself deeply in the running of such corporations. And this attitude produced significant effects on the operation of Kelon.

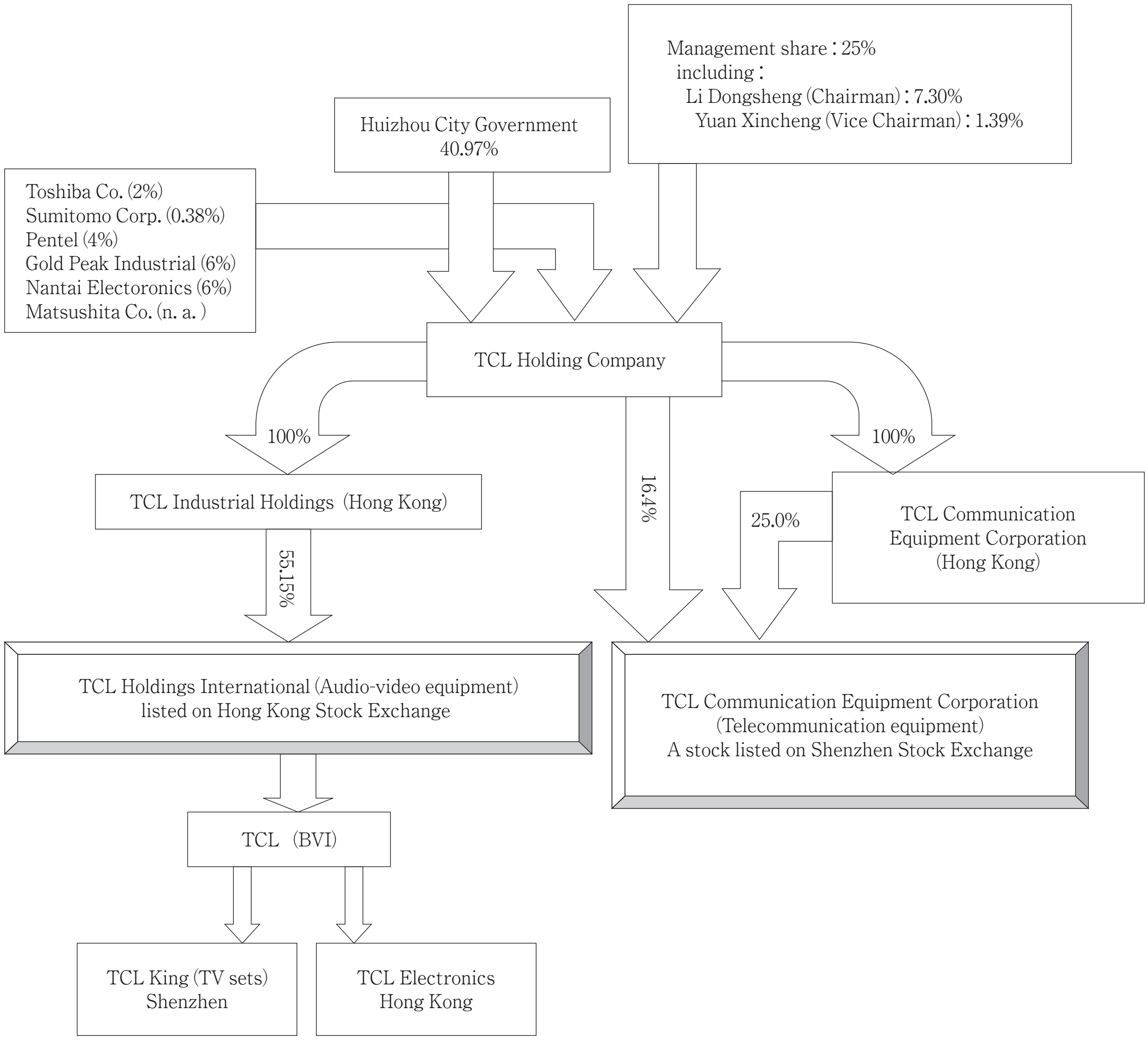
4.3.4 From Wang Guorui to Xu Tiefeng

The performance of Kelon in 1999, the first year of Wang Guorui's reign after he succeeded to Pan Ning, was not so bad. In March 2000, Wang Guorui carried out a sweeping reshuffle of the management, unseating the five vice presidents who had helped develop Kelon as Wang Guorui's comrades in arms, and replacing them by a five-member "parachute troop" of specialists brought in from outside the company. Included among the paratroopers were: Li Guoming who, after successfully helping Kelon's listing its H share in the Hong Kong exchange market, had been serving as a link between investors in Hong Kong and Kelon, and who was now appointed vice president in charge of finance; Qu Yunbo, formerly a marketing consultant, who was appointed vice president in charge of marketing; and Zong Xinyu, also formerly a consultant, who was appointed vice president in charge of corporate strategy. In addition to carrying out this drastic organizational reshuffle, Wang Guorui tried to change the company's orientation very rapidly, by implementing measures such as diversification of its product line-up, and a switch in the marketing method. These measures were met with strong voices of opposition and criticism raised from within the company, and from local dealers and sales agents, and die makers and other suppliers, with the result that the company's operation was thrown into confusion.[19] And all of a sudden in June 2000, Wang Guorui announced that he himself would resign the post of President and become Chairman, and Xu Tiefeng, then Vice Governor of Rongqi Township Government, would fill the post of President. Subsequently in October the same year, Li Guoming, whose name was associated with the popular image of Kelon as "a corporation in which the financial people have a strong say," left Kelon; and by the end of 2001, all of the five "paratroopers" resigned their posts. After assuming the office of President, Xu Tiefeng, instead of going about straightening out the confused situation, has staked out, perhaps in the hope of making a new departure, an expansionary strategy which proposes to change the corporate identity and to start undertaking the production of small-sized household electric appliances, and thus requires additional investments.

Since Pan Ning's resignation toward the end of 1998, Kelon's top management underwent a series of personnel changes. It seems safe to say that these personnel reshuffles became necessary not because the successors to executive positions proved incompetent, but rather because the company was lacking in a mechanism for coordinating and readjusting the possible conflicts of interests between the management and other stakeholders. Given the absence of such a mechanism, it is highly probable that the decision-making process in the company will be readily politicized following a departure of an influential leader. The Chinese media as "revolutionary undertakings" ridiculed the repeated changes in the top leadership of Kelon that resulted from such politicized decision-making process.[20]

4.3.5 Difficulty in Change of Top Manager

Figure 3 Ownership Structure of TCL (as of April 16, 2002)



Note: Same as Figure 1.
Source: Compiled by the author.

In changing its top leadership, Kelon faced difficulties at two levels. At one level, it had a difficult time in coordinating internal governance involved in the discharging of one group of top managers and installation of another. At another, the way the government intervened in Kelon's operation, or the way in which governance from outside the company was performed, left something to be desired.

In the period between 1990 and 1999, Kelon basically continued to perform well in terms of the manufacturing and marketing of its main products, as it continued to hold the largest share in the domestic market for refrigerators, its main line of business, for the 10 consecutive years, and also the fifth largest share in the domestic market for air conditioners. As of 2001, Kelon still remains fairly competitive in terms of production volume, sales volume, and its brand image. Looked at in retrospect, however, it is possible to say that, even though Kelon has had chances to grow much bigger, it seems to have failed to make full use of those chances, or failed to make investments necessary for attaining a further growth. In the latter half of the 1990s, not simply Kelon, but all the household electric appliances companies in China were in need of improving their business strategies as the prerequisite for growing further. Compared with the considerable progress they had already made to expand their production capacities, their marketing capacities were falling behind. It was urgently necessary for these companies to overcome this problem by allocating greater portions of their resources to the improvement of their marketing capacities.

When pressed to change its strategy, Kelon decided to meet the challenge not only by reorganizing its marketing section, but also by carrying out a personnel reshuffle to unseat the founder as the embodiment of an out-dated culture. As a result of making this decision, Kelon had to simultaneously work on the task of changing its strategy, or reforming the way it carries out its business, and on the task of reforming the very structure of its corporate governance by choosing its new leadership. Wang Guorui's attempt to grapple with these tasks by radically reshuffling the management fell through because of a fierce opposition of the other stakeholders. For the first time in 2000, Kelon posted a deficit amounting to 670 million RMB on a consolidated account basis.[21]

After its effort to simultaneously change its strategy and corporate governance failed, Kelon's operation was thrown into disorder. If a company gets caught in a situation like this, it is usually considered the responsibility of its main stakeholders, such as the largest shareholder and major creditors to take actions to iron out the tangle. The actions taken by the major stakeholders of Kelon, which were supplying funds to it, were as follows. In the period from 1999 to March 2001, the main outside investors composed of influential financial institutions, including Citibank, instead of taking a strong initiative in the governing of Kelon, sold off their own holdings of Kelon's stocks. As a result, the stock price fell so sharply that in October 2001 Kelon had to purchase its own H share to sustain the stock price. On the other hand, Kelon's liabilities consisted mostly of liquid liabilities resulting from trade credits, and the amount of borrowings from banks was small, which meant that there was no influential creditor, which in turn meant that Rongqi Township Government had a very large say as the largest shareholder. As if catering to the wishes of Rongqi Township Government, Xu Tiefeng, the former Vice Governor of the township, was appointed to the post of Kelon's President. At the time some doubts were expressed as to whether the appointment of the former government bureaucrat to the post of president of the listed company was indeed the best available choice.

When faced with the need to change its corporate strategy, Kelon tried in vain to implement a change concerning governance concurrently with changing its corporate strategy, throwing its operation into confusion and instability. But given the fact that the township government was its most influential stakeholder, it was subjected to the governance enforced primarily by the township government, and in accordance with its own viewpoint. And this explains why Kelon's operation as a whole fell into confusion and disorder. As if trying to bring the state of confusion to an end, Ronggui Township Government (note that Rongqi Township and Guizhou Township merged with each other in 2000 to form Ronggui Township) announced on November 1, 2001, that of the 34.6% of its holdings of Guangdong Kelon Electric's share, it would sell 20.6% to Shunde Greencool Enterprise Development Corporation. As a result of this transaction, a private corporation as the largest shareholder of Kelon replaced the township government, and Kelon was privatized. We will return to this point later.

4.4 TCL

TCL first distinguished itself in the production of wire line telephones, and then entered the field of TV manufacturing, becoming one of the largest TV manufacturers in China. Having started as a state-owned enterprise, but without any outlays of capital funds from the government, the corporation is considered affiliated with the government only nominally, but not in practice. Aware that the situation such as this is not conducive to procuring funds from outside, the corporation has managed to procure the funds necessary for financing its growth by adopting a strategy that attaches top priority to efficient use of funds. Having been privatized early on by means of the management and employees' buyout system, the corporation is now trying to dissociate itself further from the government.

4.4.1 The Start-up of TCL without Govenment's "Consideration"

The company group now known as TCL started as Huiyang District Electronics Industry Corporation, which was established in 1980, with 50 million RMB borrowed from a public source but without any equity capital invested by the government. At its inception it was launched as a corporation resulting from reorganization of the former Electronics Industry Division, the Bureau of Machinery Industry of Huiyang District Government. In 1981, Huiyang District Electronics Industry Corporation established with corporations in Hong Kong a joint venture firm called TTK Home Electric Corporation, a manufacturer of magnetic recording tapes, and its tapes sold well and began to compete harshly with imported tapes of the Japanese firm TDK. However, when TDK sued the joint venture firm for infringing upon its intellectual property rights, Huiyang District Electronics Industry Corporation established a new joint venture with Hong Kong capital, TCL Communication Equipment Corporation, a manufacturer of wire line telephones.[22]

After holding a certain share of the wire line telephone market, TCL in 1992 decided to enter the area of TV manufacturing. At the time, there were a large number of new entrants into the TV manufacturing industry, which was assured of a high profit because it was under lax price regulation. However, TCL was not designated by the government as an approved manufacturer, and lacking in government approval, it was not able to borrow funds from banks. Unable to procure funds necessary for making investment in its own plants and equipment, TCL decided to make inroads into the TV manufacturing business in earnest through a very unique approach, namely, the approach of procuring TVs from other companies on an OEM (original equipment manufacturing) basis for sale under its own label, rather than building its own plants for manufacturing TVs for itself. In April 1995, TCL established Huizhou King Audio-Visual Electronics Co., Ltd. as a joint venture with Changcheng Electronics Group in Hong Kong, and secured the production capacity for manufacturing 1.2 million color TVs per year, in return for providing the joint venture with an intangible asset of a marketing network which had established through the marketing of TVs under its own bland and wire line telephones.[23] Subsequently, TCL continued to increase its share in the TV market by capitalizing on its superb marketing capability, and after the TV price war of 1996 was over, its share in the domestic market jumped to third place or higher.

4.4.2 The Cash Flow Management Model

Despite its status as a state-owned corporation, TCL in reality has received little financial support from the government. Both at the time of its inception, and at the time of its entry into the manufacturing of TVs, it was unable to obtain the government's funding or preferential access to bank loans. Despite these odds stacked against it, TCL has managed to undertake investments necessary for its growth, thanks primarily to its unique management strategy.

TCL's management strategy is unique because it gives overriding priority to allocating management resources to marketing activities. When the company tries to make inroads into a certain market, it procures products from other companies under OEM arrangements, sells these products under its own label through its own marketing network, and thereby secures and expands its market. Only after the company secures a certain market share, its starts investing in plants and equipment, and starts undertaking the in-house manufacturing of the product. The strategy was first put into effect when the company made inroads into the TV market, and was subsequently applied to a series of other products, such as audio-visual products, washing machines, refrigerators, air conditioners, switches for light electrical appliances, and mobile phones.

It was as early as 1990, much earlier than other household electric appliances manufacturers of China, that TCL began to establish its own network of wholesalers. Having its own marketing network was important for TCL in two respects. First, and naturally, such a network was important as a means of enabling it to sell the products bearing its label and collect the payments for the products without fail. In this regard, the marketing network went a long way toward helping the company retain a portion of its profits as the most important source of finding. And second, the very investment in the marketing network gained in value over years and became an important asset, for use by the company in launching joint ventures with other companies, especially foreign companies with advanced technological expertise. At the time of the establishment of TCL Communication in 1985, TCL, lacking in both technological know-how and an investment fund, had no choice but to rely on some foreign corporations. The only comparative advantage TCL could boast of at the time was the domestic marketing network of distributors affiliated with the then parent company of TCL, Huiyang Electronics Industry General Corporation, and TCL was able to establish the joint venture by capitalizing on this comparative advantage.

TCL's present operations can be broken down as follows, in the chronological order by which they proved successful: 1) audio-visual appliances including telephones and TVs (with TCL, as of the end of 2000, holding the largest, near 50%, share in the domestic market for telephones, and occupying the top position in the marketing of color TVs on a value basis); 2) light electric appliances including switches for residences (undertaken by TCL International, which enjoys the largest market share); 3) white goods such as washing machines; refrigerators, and air conditioners; and 4) personal computers (with TCL holding the fourth largest market share).[24] Most of TCL's undertakings in these product areas, which now boast large market shares, were originally launched not on the basis of its technological competence, but rather following a particular "equation" or dictum which ordains that: in making inroads into a new product area, be sure to procure the products from other companies on an OEM basis, for sale under the company's own label, and through the marketing network of its own; and the launching of in-house production, by way of buying out the supplier companies or launching joint ventures, should wait until after a certain market share has been secured. This method of starting out with the marketing of a new product procured through an OEM arrangement and then switching to in-house production was first applied successfully to its TV business, and was later applied to white goods and other products in 1999 and after.[25]

4.4.3 Distance from the Government

TCL has thus grown by financing its investment funds out of cash flow generated from its operating profits. Having to finance its growth by its own cash flow means that TCL has not had any leeway to make excessive investment, and that it has not been able to afford to make decisions that would run counter to the interests of outside stakeholders.[26] TCL had to adopt this strategy of financing its growth by its own cash flow because it could not receive strong support from the government, but the strategy has had the effect of freeing the company's present operations from strong government intervention. And when companies across the country were allowed to reduce the percentages of government-owned shares, TCL quickly took steps toward privatization by letting its employees purchase TCL Group Corporation's shares owned by Huizhou Municipal Government.

4.5 Privatization as a Means of Avoiding "Government Risk"

The foregoing three case studies on three leading household electric appliances manufacturers of China have examined the relationships between these corporations and the government as a major shareholder, the relationships between the government and the corporations' strategies, and their attitude toward privatization. Now, looked at from the standpoints of these companies, what have been the main implications of the selling of state-owned shares, or privatization?

4.5.1 Distance between the "A Clariting Ownership" and "Privatization"

Corporate reform concerning ownership in China is carried out in two stages: settlement of ownership, and the selling of state-owned shares. With regard to the first stage, corporations that were established in the period of planned economy were regarded as being owned by the entire people of the country, with no concrete definition made as to how the ownership of a specific company should be divided among its various stakeholders. In these companies, problems arise both in case a company is making a profit, and in case it is losing money. In case a company, whose owners are not well defined, is making a profit, it is not clear as to who has the right to decide on how to dispose of this profit. So long as the company has ample investment opportunities whose discounted present values are positive, it may keep investing in such opportunities. But when a company runs out of investment opportunities having positive discounted present values, and if its owners were known, it would be able to distribute the profit to these owners in the form of dividend. But since its owners are unknown, it cannot distribute the profit to them as dividend. In such a circumstance, the profit will be accumulated within the company without being put to meaningful uses, or will become part of a free cash flow for use in wasteful investment or consumption.

On the other hand, in case the company's operation does not go well, problems also arise. Assume, for instance, that it falls into a state of over indebtedness, with its total debts exceeding its total assets. If the company's shareholders were known, they should decide to take responsibility by repaying the debts with their own investment money. But since its shareholders are unknown, such a decision cannot be made, with the result that the creditors interests, who should otherwise be protected, will not be protected.

These problems arise if it is not clear as to who should receive the benefits and take the responsibility on behalf of the shareholders. These problems were not limited to state-owned companies, but were common to village and township companies and collective companies as well. Thus, the need to determine corporate ownership in order to overcome these problems emerged as an important focus of corporate reforms in China in the early half of the 1990s.

4.5.2 "Government Risk"[27]

The second stage of corporate reforms concerning ownership is the selling of state-owned shares. Since this step was politically approved at the 15th Party Congress in 1997, it has been put into effect and has been a focus of much discussion. There are several reasons justifying why state-owned shares in corporations should be sold to private shareholders. The most important reason looked at from the perspective of the companies concerned, as evident in the foregoing three case studies, is the fact that having the government as a main shareholder involves a high risk, in the sense that there is a strong likelihood that the government's decision or purpose as a shareholder of a company and the purpose of maximizing the corporate value often contradict with each other. As evident in the cases of Changhong and Kelon, the government often has a strong say in changing a corporation's management. It is perfectly in accord with the prescriptions of the Corporate Law that the government, by virtue of being the largest shareholder of a corporation, exerts strong influence on the governance of the company. Nonetheless, it cannot be denied that the government has its own objective, and if it tries to impose that objective too strongly on the corporation, the corporation's business will be adversely affected. In the case of Changhong, if what is reported is true, Sichuan Provincial Government, just in order to improve statistical records of the province, went to the extent of removing the top manager of the company who tired to cut back on the company's excessive inventory. In the case of Kelon, too, it is said that Wang Guorui, the second-generation President, was forced to step down by the company's largest shareholder, Rongqi Township Government, because local dealers did not take kindly to his policy of reshuffling the managerial staff and reorganizing the marketing network as a means of helping the company grow from a local company into a national giant. If these pieces of information are true, it must be concluded that the decisions made by Sichuan Provincial Government and Rongqi Township Government were clearly at odds with the purpose of maximizing the corporate values.

The government has its own objective, and it is quite natural for such an objective often proves to be different from the objective pursued by a corporation. However, by being the largest shareholder of a company in present-day China, the government seems to run the risk of doing harm to the corporate value. In this sense, a corporation having the government as its largest shareholder is burdened with a "government risk." In order to avoid this risk, it is desirable for companies to publicly release their shares held by the government, and become privately owned companies.

4.5.3 The Progress of the Privatization in the Three Companies

In TCL and Kelon, out of the three companies dealt with in this paper, privatization is already under way, with concrete details of the progress being reported in the Chinese media. Privatization is carried out not only through the selling of state-owned shares in the stock exchange market. Presumably, many of the shares are sold through private negotiations, because firms often expect that by taking this approach they will be able to enjoy, after privatization, a larger room of freedom in practicing corporate governance and in devising business strategies in ways advantageous to themselves.

(i) Changhong

Changhong posted a deficit in its mid-year report in 2001, the first report on the settlement of accounts published after Ni Runfeng's recovery as President. However, as of the end of 2002, no announcement has been made as to whether Sichuan Changhong Electronic Group Corporation, the holding company for the company group as a whole, is scheduled for privatization.

(ii) TCL

Letting its employees purchase the state-owned shares in TCL Holdings carried out privatization of TCL. In March 1997, TCL Group was formally delegated by Huizhou Municipal Government to exercise the property right of the state-owned assets based on the consignment management contract over the state owned asset. Then, in May of the same year, it reorganized its three specialized groups into TCL Group Corporation. At that occasion, the shares of TCL Group Corporation were divided into 59% under Huizhou Municipal Government's holdings, and 41% under the management and employees' holdings. The holdings of the managers as of January 2001 stand as follows: Li Dongsheng, President, holding 5.758% of the total stock, and RMB Xincheng, 1.048%.[27] Subsequently, TCL listed the shares of TCL Holdings International in Hong Kong, transferring its TV business under the latter's umbrella. Thus, TCL group came to have two listed companies, namely, TCL Communication, a listed company within China, and TCL International, a listed company in Hong Kong. While TCL subsequently have taken steps to transfer the shares of its main subsidiaries to, and concentrate the power of control in TCL, the shares of these two listed companies have been concentrated in TCL Group Corporation, the holding company for its entire corporate group.

(iii) Kelon

In the period from 1999 to 2001, the top manager of Kelon was changed twice, first from Pan Ning, the founder, to Wang Guorui, and then from Wang Guorui to Xu Tiefeng. On November 1, 2001, one day preceding the change in the leadership from Wang Guorui to Xu Tiefeng, Kelon announced that 20.4% of the 34.6% of the shares of Guangdong Kelon Electric Co. owned by Ronggui Township Government would be sold to Greencool, a privately owned manufacturer of refrigeration medium. And on the following day, it was reported that a total of 8 directors of Kelon, including President Xu Tiefeng, submitted their resignation. The government is reported to have the intention to sell all of the remaining shares under its holdings, while Greencool has responded to the report with a comment that it is ready to increase its holdings of Guangdong Kelon Electric's shares up to 29.9%.

A private company having a patent for the manufacturing of environmentally friendly refrigeration medium, Greencool has its head office in Beijing and its plants in Hubei, Tianjin, and other localities. In purchasing shares of Kelon, it established Shunde Greencool Enterprise Development Corporation in Shunde, and let it own the purchased shares. Greencool's purpose of buying into Kelon's shares is to acquire a full range of technological capacity to manufacture not only refrigeration medium but also final products such as refrigerators and air conditioners, and to boost its competitiveness by supplying environmentally friendly refrigerators and air conditioners. It can be concluded that through this purchase of Kelon's shares, the management rights over Kelon are to be handed over from the founding managers to outside entrepreneurs of a private company.

The approach to privatization adopted by Kelon is different from the one adopted by the two other household electric appliances manufacturers based in Shunde, namely Midea and Galanz. Both Midea and Galanz proceeded with privatization by letting their present managers and employees purchase the shares held by the government. The difference in the solidity of the three companies' managerial systems seems to have led to the differences in their approaches to privatization.

After Kelon made its decision about privatization, it was reported that Kelon Group Corporation was asked to repay bank loans totaling more than 400 million RMB, an amount fairly close to 560 million RMB, the total selling price of the government-owned shares (*Southern Weekend*, November 30, 2001).

Couclusion: The Significance of Privatization for the Company

Before concluding this paper, let us briefly ponder over the question of whether Chinese corporations are being governed well. On the basis of the foregoing three case studies on the leading household electric appliances manufactures, the following points can be made.

A glance at the capital structure of Chinese corporations, namely, the composition of their creditors and shareholders, reveals that the government is an enormously large presence. In the case of a listed company, to begin with, when the company becomes able to procure funds as a resulting of having been listed on the stock exchange, its ratio of total assets to liabilities usually decreases. The remaining debts do not necessarily consist of borrowings from banks and other financial institutions, but consist mostly of accounts payable and other forms of trade credits. This means that the presence of creditors is relatively insignificant. Similarly, a glance at the composition of shareholders of group corporations, which are the holding companies of company groups, reveals that shares are concentrated relatively heavily in the largest shareholders. And in the cases of state-owned enterprises and village and township enterprises, governments often own largest portions, and sometimes even as much as 100%, of their shares. Moreover, these group corporations often serve as the largest shareholders of the listed companies belonging to the groups. In other words, for a listed company in China, either the government or the holding company under strong influence of the government is the largest internal shareholder, which exerts a decisive influence on its operation.

Given this structure, there is a strong likelihood that a holding company under strong influence of the government will behave in such a way as to exploit external, minority shareholders of the affiliated listed company. In other words, the structure of corporate governance in China works in such a way as to enable group corporations to behave just like the founding families of giant family concerns in Southeast Asia. This is an important factor that ought to be kept in mind when assessing these group corporations as potential targets of securities investment.

Moreover, the situation wherein the government serves as the largest shareholder of a corporation entails a problem. Under the Chinese Company Law, it is perfectly legal for the government to be a shareholder of a corporation. Nonetheless, the objectives of the government and those of corporation are often at odds with each other on many points. In the light of this fact, it is important for a corporation to deal squarely with the question of how best it can remove the risk of the government's going out of control. The most straightforward response to this question is to reduce the percentage of the government's shareholdings, that is to say, to privatize the company. And corporations performing well are eager to reduce the ratios of the government's shareholdings as soon as possible, and thereby to avoid "government risk." In the months or years ahead, such companies will show greater determination to carry out privatization on their own initiative.

(Mariko WATANABE)

Postscript

On April 9, 2002, TCL Group Corporation signed a letter of intent to hold negotiations concerning a comprehensive tie-up with Matsushita Electric Industrial Co., Ltd. One week later on April 16, TCL Holding Company reorganized itself from a private limited company into a shared corporation, and held a shareholders' meeting to launch the new company. At that meeting, it was announced that of the 58% shares of TCL Holding Company owned by Huizhou Municipal Government, shares totaling 18.38% were sold to Toshiba (2%), Sumitomo Corporation (0.38%), Pentel (4%), Incan Industrial, a Hong Kong-based voltaic cell manufacturer (6%), and Nantai Electronics, a Hong Kong-based household electric appliances manufacturer doing production under contract and listed on NASDAQ, U.S.A. (6%). With this sale, Huizhou Municipal Government's share decreased to 40.97%, changing the city government's status from the absolutely largest shareholder to a relatively largest shareholder. It has also been reported that Matsushita, with which TCL has started negotiating on a comprehensive tie-up, is scheduled to purchase shares of TCL Holding Company (*Nikkei Business,* April 22, 2002), and that China International Financial Corporation in the capacity of the advisor to TCL has started to prepare for the floatation of TCL Group Corporation's shares (*Southern Weekend,* March 15, 2003).

One factor inducing TCL to carry out privatization of shareholdings at an accelerated pace is reported to be that, before the five-year term of the <<Contract on Consignment Management over the State-owned Assets>> the company concluded with Huizhou Municipal Government in 1997 is to expire shortly, the present management is trying to secure the power of control over the company. The Contract stipulates that in case net assets of TCL increase by more than 10%, the increment in excess of the 10% mark may be used for boosting capitalization, certain percentage of which may be distributed to the management or offered to the management for purchase at a preferential price, the management has increased its shares by taking advantage of this stipulation.

Notes:

1. Classens, Djankov, Lang, "The separation of ownership and control in East Asian Corporations," *Journal of Financial Economics,* 58, 2000, pp.81-112. Faccio, Lang and Yong, "Dividends and expropriation," *American Economic Review,* Vol. 91, No. 1, 2001.
2. *The Economist,* "Asian Business Survey," April 7, 2001.
3. The case studies on Changhong and TCL are based on the analysis presented in Watanabe Mariko, "Shihon kozo to kigyo kodo: terebi kigyo 2-sha no hikaku kara"(The capital structure and corporate behavior: A comparison of two TV manufacturing firms), in Marukawa Tomoo, ed., *Chugoku Kigyo no Shoyo to Keiei* (Ownership and management of Chinese corporations), Institute of Developing Economies, 2002.
4. The descriptions about Changhong in this section are based mainly on the 1998 to 2000 issues of the annual report of Sichuan Changhong Electric Co., Ltd., as presented in the company's web site http://www.changhong.com, and on the author's interview with Vice President Liu Tibin of Sichuan Chaghong Electronic Holding Company conducted on September 16, 2000.
5. Hao Yanshu, "Kokuyu kigyo no seicho to suitai ni yoru sangyo kozo henka e no eikyo: Terebi sangyo no jirei o chushin ni shite" (Effects of state-owned corporations' growth and decline on industrial structural changes: An analysis with emphasis on a case study of the TV manufacturing industry), *Chugoku no Keizai Kozo Chosei to Kin'yu Zaisei Mondai* (Economic structural adjustments and financial and fiscal problems in China), Institute of International Trade and Investment, 2000.
6. Watanabe Mariko, "Chugoku no kaden kigyo no bijinesu moderu" (A business model for electric appliances firms in China), *Ajiken World Trend,* 2000.
7. Watanabe, ibid.
8. An excess investment takes place in a situation where investment is made even in an investment project with a negative discount present value. On the other hand, a situation where investment opportunities with positive discount present values are not yet fully exploited due to shortage of funds and other factors is called one of under-investment.
9. Chen Yongzhong, Wang Junmai, and Pei Houqin, "Sichuan Changhong," in Zhogguo Gaige yu Fazhan Baogao Zhuanjiazu, *Growth Experiences: Case Studies of Competent Large Companies in China,* Shanghai: Shanghai Yuandong Chubanshe, 1999, p. 216.
10. For a detailed discussion on this matter, see Watanabe, "Chugoku no kaden kigyo ...," op. cit.
11. Given the fact that the value of assets per share decreased, consequent upon the decrease in the listed company's assets and the huge outflow of cash, all the shareholders had to bear the risk of poor business performance. Nonetheless, the Holding Company, Changhong's largest shareholder, appears to have been compensated for the loss through separate, but related dealings with Changhong. Needless to say, ordinary shareholders were not compensated for the loss. In this sense, one might say that the interests of minority shareholders were left unattended, or rather "exploited."
12. "Kelon: Why in Trouble Again?," parts 1 and 2, on *The Beijing Youth Daily's* web site, dated on November 9, 2001.
13. The author's interviews with Xu Dejian of the Japan Representative Office of Kelon, on September 24, 1998 and October 19, 1999, and with Xu Tiefeng, President of Guangdong Kelon Electric Co., Ltd., on February 12, 2001.
14. *The Beijing Youth Daily's* web site, dated on November 9,2001.
15. *The Beijing Youth Daily's* web site, dated on November 9,2001.
16. Wang Xiaobing and Ali Lun, "Kelon Collapse," *Caijing Magazine,* February 2001.
17. "Kelon Try to Sooth Dealers," on *The Guangzhou Daily's* web site, accessed on November 9, 2001.
18. Lu Liling, "Guangdong Shunde: Making transition of the roles of the government through ownership reform," in Zhongguo Gaige yu Fazhan Baogao Zhuanjiazu, *Choice of Reason: An Interim Appraisal of the Reform of State-owned Small Enterprises,* Shanghai: Shanghai Yuan dong Chubanshe.
19. Wang and Ai, op. cit.
20. "A New Phase of Kelon's Revolution," on *The Southern Weekend's* web site, dated on November 5, 2001.
21. Guangdong Kelon Electric Co., Ltd.'s mid-year report for 2001.
22. Zhou, "I'm serving for 10 thousand employees (interview with Li Dongsheng)" *Xin Zhou Kan* (*News*

Weekly) June, 1998.

23. Liu Lu and Yang Xiufa, "Shenzhen TCL," in Zhongguo Gaige yu Fazhan Baogao Zhuanjiazu, *Growth Experiences: Case Studies of Competent Large Companies in China,* Shanghai: Shanghai RMBdong Chubanshe, 1999, p. 250.
24. The author's interview with Li Dongsheng, President of Guangdong TCL Group Corporation, on February 13, 2001.
25. The author's interview with Li Dongsheng, President, Yuan Xincheng, Executive Vice President, and Yamane Chikao, Chief Engineer, on February 13, 2001.
26. There is a possibility that TCL's investments have fallen short of the necessary or adequate levels, but given the present size of TCL, the degree of under-investment, if any, must have been insignificant.
27. Watanabe, M. "Holding company Risk: a final step of state enterprise reform and an emerging problem of corporate governance in China, " *China Economic Review,* Vol.x, No. xx, 2002 called this risk "holding company risk" instead of the government risk.
28. The report to the board of directors of TCL International, submitted on January 9, 2001, by Anglo Chinese Corporate Finance, a consulting company.