GIDE
GIDE LOYRETTE NOUEL

PUBLICATION | M&A / CORPORATE | CHINA

November 2014

Can China loosen up? New wave of SOE privatization underway

Summary

Since the Third Plenary Session of the 18th Communist Party of China Central Committee in November 2013, several government announcements have indicated that a new wave of privatization is underway. This time, a greater number of large state-owned enterprises at the national level will be involved. Past privatizations were criticized both because of the way they were implemented and because of their consequences. This article analyzes how past waves of privatizations were implemented in China to identify room for improvement, notably through a comparison with other privatization methods. Recent announcements from Chinese authorities suggest that China is willing to address grievances with certain new measures for the latest wave of privatizations.

Past waves of privatizations

Privatizations of Chinese state-owned enterprises ("SOEs") have been a part of China's economic reform for decades now. Yet, the various texts, decisions, circulars, communiqués and publications on this subject rarely, if ever, uses the word or refers to SOE restructuring as such. In this area, as in other areas where China has implemented economic reforms, the government has used a cautious approach, best summed up with the famous idiom "crossing a river by feeling the stones" (摸着石头过河 - *mōzhe shítou guòhé*), whereby partial reforms were implemented in an experimental manner, often in a few regions, and expanded only upon proven success.

Since the mid-1990s, faced with a bloated public sector that was proving to be harder and harder to manage, the central government made a monumental decision to "grasp the big and let go of the small" (抓大放小 — *zhuā dà, fàng xiǎo*). Tens of thousands of small and medium-sized SOEs were restructured, sold off, closed down and/or privatized.

However, for larger SOEs, the process has been somewhat different - namely, slower and carried out in a piecemeal fashion. Often, after an initial phase of restructuring, only a small amount of their equity would be sold to private investors, causing them to be caught in an intermediate state that came to be known as "one-third privatized". As this process evolved, a large number of these SOEs have finally experienced a change of control, becoming "two-thirds privatized" or even entirely sold to private hands.

Still, many people criticize the way that privatizations have been implemented in China. Larger SOEs are still run either by state departments or by state-owned asset management companies. Experts warn that the government's continued dominance in key sectors of the economy will be a constraint on productivity, innovation and creativity. In addition, these privatizations have not been accompanied by a balancing or normalization of conditions of entry for Chinese investors in their own market, with many privately owned companies suffering from difficulties such as access to financing, competition, and access to markets.

With these grievances in mind, Chinese authorities have announced plans for a new round of restructuring, led by an opening of key industries to private capital, modernization of SOEs, and support for the development of the private sector. This renewed enthusiasm for change presents a great opportunity for China to address the frustrations of its critics. Yet, given the framework for transfers of state-owned assets and equity in China, is there any room for change?

The new plan

A joint report published early last year by the World Bank and Development Research Center of the State Council, called “China 2030: Building a Modern, Harmonious, and Creative High-Income Society”[1], laid out a possible development path for China to become a high-income country and recommended several measures for mitigating its risks over the next 20 years. One measure was the necessity to redefine the role of SOEs and end their monopoly in some core industries, diversify ownership, reduce barriers to privately owned enterprises, and facilitate access to financing for small and medium-sized enterprises.

Chinese leaders seem to have taken note of the report, if not exactly eager to fully embrace its suggestions. When top government leaders met at their third plenary session in November 2013, they emphasized in a communiqué issued at the end of the session that China must pursue deeper reforms - particularly with regard to its economy - to improve “socialism with Chinese characteristics” and modernize the country’s governing system. However, they also reaffirmed the dominant role of public ownership. The government, as the leader of the state-owned economy, will encourage, support and guide the non-public sector insofar as it enhances the country’s vitality and creativity.

One of the Central Committee’s directives was not just to uphold the “basic economic system”, but to improve it. To this end, the sixth, seventh and eight directives call for developing a “mixed-ownership economy”; pushing SOEs to improve their management; and supporting the “healthy development” of the non-public sector of the economy. More specifically, the mixed-ownership economy should be “characterized by cross-shareholding and mutual integration of state-owned capital, collectively owned capital and non-public capital”. SOEs should “adapt to the new market-oriented and internationalized framework” by standardizing their decision-making, preserving and increasing their asset value and engaging in fair competition. Non-public companies should be encouraged to participate in these SOE reforms, and non-public investors should also be encouraged to have controlling stakes in mixed-ownership enterprises.

Following the Central Committee meeting, numerous central authorities, including the State Council, State-Owned Assets Supervision and Administration Committee (“SASAC”) and National Development and Reform Commission, announced the sectors that will be subject to restructuring[2] and then opened to private capital. These sectors include the railways, petroleum and petrochemicals, natural gas, telecommunications, environment, healthcare, banks and some areas of national defense - all key industries currently dominated by state monopolies and oligopolies.

[1] World Bank and the Development Research Center of the State Council, P. R. China. 2013. *China 2030: Building a Modern, Harmonious, and Creative Society.* Washington, DC: World Bank. DOI: 10.1596/978-0-8213-9545-5. License: Creative Commons Attribution CC BY 3.0.

[2] Through separation of activities, creation of several corporations to oversee specific activities, separation of shareholding and management, etc.

In fact, the first reforms were already underway. Earlier that year, in March, the Ministry of Railways was split into two, one of the largest shake-ups in the Chinese bureaucracy in years. Under a State Council decision[3], some regulation and oversight functions were transferred to a State Railway Administration under the Ministry of Transportation, while a new company, China Railway Corporation, was charged with commercial exploitation of the railways.

The State Council also suggested that the company's function as a company should be reinforced, that it should be driven by profits (notably through the exploitation of its real estate assets), that it should be divided into several departments to force competition (such as separating transportation activities from the manufacturing of trains or commercial exploitation of trains), and that the entry of private capital should be allowed to split up its monopoly. On 13 February 2014, China Railway Corporation announced that it had launched a valuation of its assets.

In the petroleum and gas sector, a SASAC official said in November 2013 that the National Energy Bureau was drafting measures to open infrastructure to competition. How to divide infrastructure projects - for instance, by region or by type of activity - is currently being studied. The SASAC official also said that the government will seek high-caliber strategic investors, including foreign investors, in this move toward restructuring. In any case, the three oil giants - PetroChina, Sinopec[4] and CNOOC - already appear concerned by these reforms and the opening of their capital to privately owned companies.

More recently, in March, the Chinese bank regulator announced that it would test the possibility for private companies to create five private banks as a first step, with a view to increase competition and loans to small companies. Alibaba, Tencent, Fosun, Wangxiang and six other private Chinese companies were chosen to be part of this test program. And in July, SASAC announced that six SOEs - China National Pharmaceutical Group (Sinopharm), China National Building Materials Group (CNBM), State Development & Investment Corporation (SDIC), China National Cereals, Oils and Foodstuffs Corporation (Cofco), China Energy Conservation and Environmental Protection (CECEP) and Xinxing Cathay International (XXCIG) - would be next in line for further privatization as potential test cases for other SOEs[5].

The privatization process

Chinese laws mandate three main principles under which any transfer of state-owned assets or equity ("SOA") must operate. First and foremost, the transfer should be conducted openly, fairly and impartially. It must also protect the legitimate interests of the State and all other parties. Lastly, it must be conducted publicly in accordance with the law[6].

Roughly speaking, transfers may be done through auction, bidding or negotiated agreement[7]. Regardless of which route the transferor chooses to go, it must first conduct a feasibility study and formulate a transfer scheme, including for the placement of its employees (where necessary). It must also conduct an audit of

---

[3] *Proposals of the State Council for Institutional Reforms and Functional Transformation* of 14 March 2013.

[4] Sinopec has already opened its capital to private investment.

[5] SASAC's 15 July 2014 news conference on SOE pilot reforms (http://news.xinhuanet.com/english/china/2014-07/15/c_133486070.htm).

[6] Articles 3 and 4 of SASAC and the Ministry of Finance's *Order on the Issuance of the Tentative Measures for the Administration of the Transfer of State-Owned Assets and Equity in Enterprises* ([2003] No. 3 of 31 December 2003).

[7] Article 5 of SASAC and the Ministry of Finance's *Order on the Issuance of the Tentative Measures for the Administration of the Transfer of State-Owned Assets and Equity in Enterprises* ([2003] No. 3 of 31 December 2003), which also provides for the possibility of "any other means provided by laws or administrative regulations."

the SOA to be transferred, as well as appoint a valuation firm to appraise the SOA's value[8]. The valuation report must serve as the basis for the transfer price of the SOA[9] and be submitted to authorities for approval.

Upon obtaining authorities' approval for the transfer, a transfer announcement must be made in a manner aimed at soliciting a large number of potential transferees. Foreign entities are explicitly mentioned in regulations as being eligible candidates, provided that they comply with Chinese foreign investment laws[10]. In fact, SASAC has even said that "priority must be given to the private investment entities with excellent performance and good reputation that are pursuing a common goal"[11].

Following the public announcement of the transfer, if there is more than one candidate for the transfer, the transferor must organize an auction or other bidding procedure through a duly established property rights exchange center. If there is only a single candidate or if SASAC approves it, the transfer may be made through a negotiated agreement.

Under certain circumstances, authorities may terminate a transfer and file an action with Chinese tribunals to confirm the invalidity of the transfer. Sanctions are also provided in case of misconduct of an intermediary institution or approval institution.

Candidates of a bidding procedure may also file a proceeding with SASAC or the authority appointed by SASAC if they have any objections to how the bidding procedure was carried out. If SASAC confirms the results of the bidding procedure, they may apply for an "administrative review", still in front of SASAC. They can only file an action before an administrative tribunal or civil court (depending on the grounds for their action) if SASAC refuses to review their case[12].

The following chart summarizes the procedure for a transfer of an SOE's assets or equity to a private company[13].

8 The appraisal must be conducted according to the principles of authenticity, scientificity and feasibility using the procedures and appraisal methods described by law (Article 7 of the *Measures for the Administration of Evaluation of State-Owned Assets*, State Council Decree No. 91 of 16 November 1991).

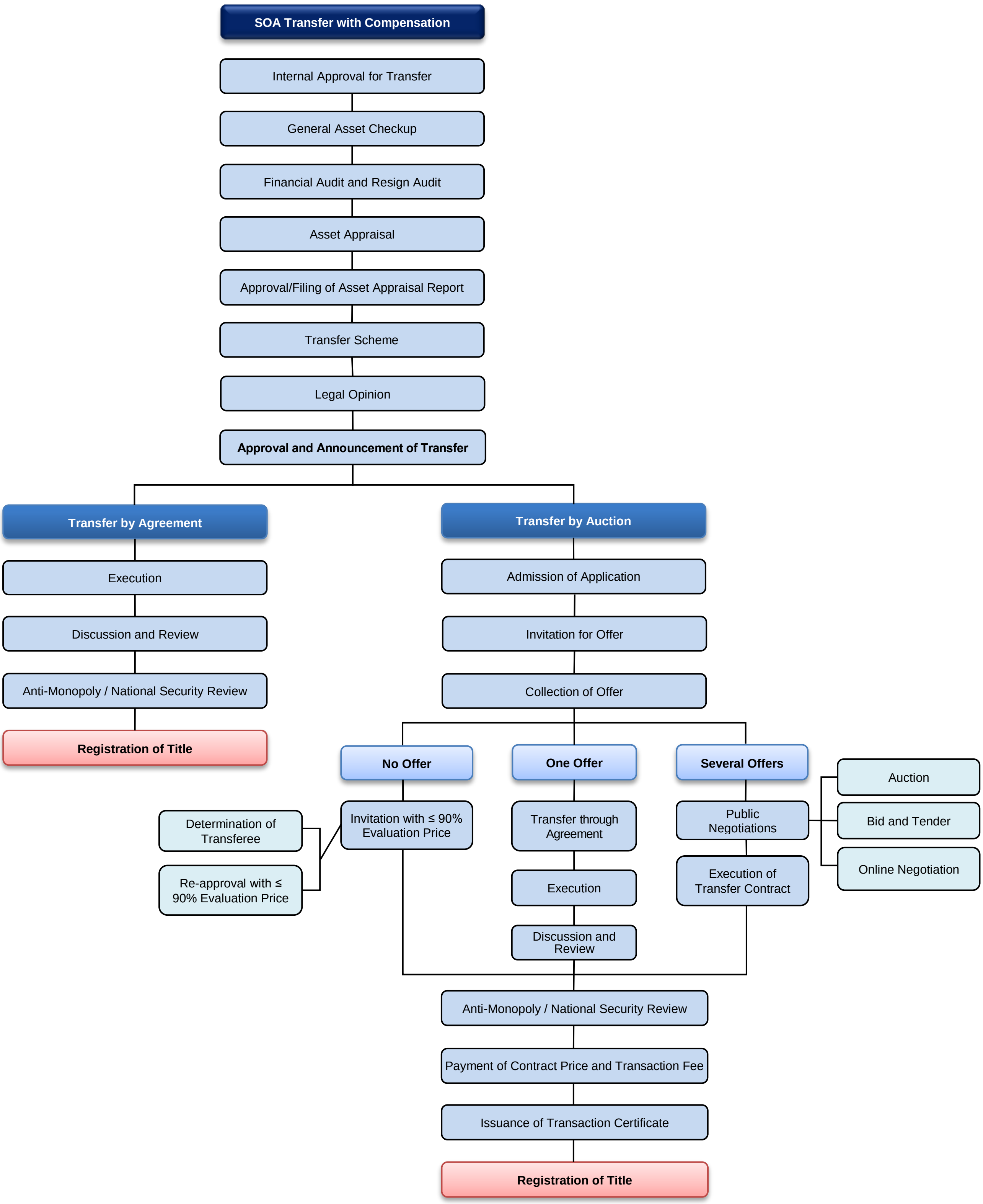
9 If the transfer price represents less than 90% of the valuation result, the transfer will be suspended and may proceed only after authorities give their approval for the transfer.

10 Notably the *Catalogue of Industries for Guiding Foreign Investment* (National Development and Reform Commission and the Ministry of Commerce's Order [2011] No.12 of 24 December 2011), which details the industries in which foreign investments are encouraged, restricted or prohibited, and the applicable foreign exchange control procedures.

11 SASAC's *Guiding Opinions on Active Introduction of Private Investment in the Restructuring of State-Owned Enterprises* (Guo Zi Fa Chan Quan [2012] No. 80 of 23 May 2012).

12 *Administrative Reconsideration Law* (Order of the Chairman No. 16 of 29 April 1999) and its *Regulations for Implementation* (State Council Decree No. 499 of 29 May 2007), *Administrative Procedure Law* (Order of the Chairman No. 16 of 4 April 1989).

13 Transfers of SOAs involving a listed SOE or financial SOE are subject to a different procedure.


SOA Transfer with Compensation
Internal Approval for Transfer
General Asset Checkup
Financial Audit and Resign Audit
Asset Appraisal
Approval/Filing of Asset Appraisal Report
Transfer Scheme
Legal Opinion
Approval and Announcement of Transfer
Transfer by Agreement
Execution
Discussion and Review
Anti-Monopoly / National Security Review
Registration of Title
Transfer by Auction
Admission of Application
Invitation for Offer
Collection of Offer
No Offer
One Offer
Several Offers
Determination of Transferee
Re-approval with ≤ 90% Evaluation Price
Invitation with ≤ 90% Evaluation Price
Transfer through Agreement
Execution
Discussion and Review
Public Negotiations
Execution of Transfer Contract
Auction
Bid and Tender
Online Negotiation
Anti-Monopoly / National Security Review
Payment of Contract Price and Transaction Fee
Issuance of Transaction Certificate
Registration of Title

New privatizations: Toward a change of method?

In practice, the development of infrastructure, increased competition, and opening of the Chinese economy have contributed to the development of private sector. Past waves of privatization have fostered the emergence of an entrepreneurial social class that possesses a strategic long-term view. In addition, several studies have documented the positive impact of privatization, including limited privatization, on firm productivity and financial performance. Far from being unable to adapt themselves, privatized companies have been one of the prime movers of reform.

Despite these positive indicators, the way privatizations have been implemented in China has still received some criticism. While the private sector has benefited from the opening of a large sector of the economy that was once reserved for SOEs, they also continue to face difficulties in taking advantage of such situation because they do not have the financial means to access it: Large state banks only lend to large SOEs. Instead, private companies remain frustrated by a lack of clear laws and fair competition, which often renders them unable to compete with the state-owned giants.

The "crossing the river by feeling the stones" method has enabled China to first test the impact of privatizations in some regions or sectors and then to adapt the method to different situations. Whatever the reasons for implementing such method (ideological grounds of preserving socialism against private capitalists; or on the contrary, shifting from ideology-based to evidence-based policymaking under the slogan of "seeking truth from facts"; the need to manage the process in a way that did not create economic and political instability; absence of satisfactory governance mechanisms), it has obviously enabled China to avoid drawbacks of the "big bang" approach to privatizations that was applied in some Eastern European countries and to contain social discontent due to job losses at levels that were manageable (though privatizations have sometimes led to tragedies). Nevertheless, at the same time, the legal basis for implementing privatizations has not been applied uniformly in all Chinese provinces, and the process has necessarily lacked transparency.

In our opinion, there exists a direct link between how explicitly a policy is officially recognized and how it is regulated: A clear policy enables clear guidance and regulations to be drafted and implemented. And clear guidance and regulations help to give confidence to the fairness of the policy's implementation. In this respect, China has never formulated an explicit plan for privatizing its SOEs, as other countries have done. For instance, in 1986, the French government began issuing a set of privatization laws, which were applied to the transfer of shares of directly or indirectly state-owned companies. An independent administrative authority, the *Commission des Privatisations* (later renamed the *Commission des Participations et des Transferts*), was created to determine the value of assets transferred to the private sector and to give its opinion on the transfer procedure and purchaser(s). Even today, these laws and administrative authority still govern such transfer procedures.

Another source of frustration is the possibility for SOAs to be transferred through negotiated agreement without first going through a public auction or bidding procedure[14]. A possibility that enables the principle of openness to be subverted by default should have well-defined limitations; otherwise it makes the entire procedure vague and non-transparent. Other jurisdictions in the world also allow privatizations to occur without an open process[15], but competitors still have the possibility to question the procedure either by

---

14 The Ministry of Finance and SASAC's *Circular concerning issues relevant to the Transfer of State-Owned Property Rights held by Enterprises* (Guo Zi Fa Chan Quan [2006] No. 306 of 21 December 2006) provides that "if industries or areas crucial to national economy have, in the process of restructuring, special requirements for transferees, or if direct transfer by agreement is a necessary part of the process of internal asset reorganization by investees," authorities may review an application for transfer by agreement.

15 In France, Decree No. 93-1041 of 3 September 1993 allowed the transfer of minority shareholdings (or majority shareholdings where the operation concerns the restructuring of companies directly involved in national defense or security or continuity of energy supply) in state-owned companies within the frame of an industrial, commercial or financial cooperation agreement.

being allowed to participate in turn to the procedure[16] or by having the possibility to bring the case before tribunals. In comparison, by forcing candidates to go through a lengthy and costly process before they can bring an action before a tribunal, China seems to be discouraging candidates from questioning the way a bidding procedure was carried out, which also impairs the efficiency of reforms.

But Chinese legal procedures for privatizations are not the only source of frustration among the private sector, and complaints do not place blame only on the way privatization has been implemented. Indeed, other factors must exist for fair competition between the public and private sectors.

As mentioned before, rather than completely handing over SOEs to private owners in one go, Chinese authorities have preferred to first create a non-state sector subject to the operation of market forces and then allow SOEs to be progressively subject to market discipline, all the while retaining state control over the means of production. The privatization methods have varied according to the kind of SOE concerned, but even now, under "Chinese privatization", the partially privatized SOEs have hardly been submissive to market forces.

Such situation obviously impairs the capacity of privately owned companies to act "at arms' length" with privatized SOEs. For instance, where both publicly owned and privately owned companies act on the market, fair competition between them is contingent on the existence of certain characteristics, such as the concept of informed investors under normal market conditions *(investisseur avisé opérant aux conditions de marché)* developed in the European Union. Under such concept, public investments are reviewed to ensure that they were realized under normal market conditions, i.e. in similar conditions to those that would have prevailed if such investments had been made by a private investor. If adapted to China, this means that except under specific and well-defined circumstances, SOEs should not benefit from better conditions than those made to private companies, in terms notably of access to some procurement contracts, concessions or sources of financing.

Also, if the way reforms are carried out is to change, so must the methods of governance. In a truly "mixed-ownership" economy, the state becomes a shareholder among others. The conditions for its involvement must be adapted and the necessary bodies put in place for there to be any level playing field. In this respect, the "China 2030" report wondered how China could best transition from its current approach to managing its portfolio of state enterprises to an approach that would be best suited for its long-term development objectives[17]. It had two notable recommendations.

First, it recommended that ownership be separated from management and that modern corporate governance practices - such as appointment of senior management, public disclosure of accounts in accordance with international practice, and external auditing - be introduced. In this respect, SASAC should relinquish control and management of SOEs to the board of directors of such companies, notably by allowing the board of directors to appoint their companies' management[18]. It could also shift the system whereby management often puts national interests ahead of those of minority shareholders. Personal benefits for management personnel should also be replaced with incentive-based reward systems as motivation for maximizing profits.

---

[16] France's Decree No. 93-1041 (*see Footnote 14*) provided for a period of 15 days between the publication of the objectives of such industrial, commercial or financial cooperation agreement, and the approval of transaction by regulators, which in practice is aimed at enabling potential competitors to question such "off-the-market" procedure.

[17] *See Footnote 1.*

[18] In fact, Chinese SOEs may be moving in this direction. At SASAC's 15 July 2014 news conference (*see Footnote 5*), officials indicated that a more effective board of directors system would be set up at Sinopharm, CNBM, CECEP and XXCIG. The boards of these companies will act as the corporate decision-making center and reduce the managerial involvement of investors.

Second, the report recommended that the government consider establishing several state asset management companies (“SAMCs”) to represent the government as shareholder and professionally manage and trade its assets in financial markets where feasible. Each SAMC would specialize in a specific sector. Most importantly, SASAC would confine itself to policy-making and oversight, and leave asset management to the SAMCs. The French State Shareholding Agency (*Agence des Participations de l’Etat*) could be a valuable model for such SAMCs.

Conclusion

With their calls for a new round of restructuring, it is clear that Chinese leaders are aware of the necessity for reforms. In fact, Premier Li Keqiang reiterated at the annual meeting of China’s legislature in March 2014 that the state-owned economy needed reforming: “[China will] set down approaches benefitting non-public capital to participate in projects together with SOEs and further provide non-public capital with projects in the industry of finance, petrol, electricity, telecommunications, resource development, infrastructure, etc.; formulate detailed measures for the entrance of non-public capital into the scope of concession; initiate reform in railway investment and financing, and open up more competitive activities in different industries and provide a platform for private capital; improve property rights protections, considering that non-public property rights should be as inviolable as public property rights.”

Given the voluntary tone of this declaration and the wide scope of the reform plans, China seems to be on the way toward a change of method in the way it carries out reforms. SASAC indicated that the goal of the pilot reforms for the first six SOEs previously mentioned is to develop new systems that can be copied elsewhere and to provide support for deepening SOE reform nationwide. But how much control are authorities ready to relinquish to the private sector? Perhaps now that many privatization methods have been tried, an explicit privatization plan can be articulated and implemented. A transparent framework, along with a new governance structure for its SOEs, could go a long way to help achieve China’s goal of transforming into a modern society.

In any case, privatization and restructuring of its key industries, as with other reforms in China, will be a huge challenge. Frustrations from previous waves of privatization can provide a guide for authorities to improve the process and create more meaningful reform. Critics not only give a bad image to the way reforms are carried out; but if conditions are overly favorable to SOEs, the reforms also will have considerable negative impact on private industry. Moreover, criticism no doubt will produce a negative image for SOE governance, which may one day compromise SOEs’ capacity to make investments abroad - for instance, in a listing procedure, where trust and reliability are crucial for small investors, or in a privatization under a more sophisticated legal system, where the exemplary nature of investors is a prerequisite.

Thus, if China is to implement meaningful reforms in restructuring its public sector, it must do more in this newest round of privatizations to change how privatizations are carried out and how its SOEs are governed. It must get rid of structural imbalances and give the private sector access to financial support and fair competition. A more transparent privatization process will improve the public’s perception of how reforms are carried out, while significant organizational changes may well lead to the modernization of the wider Chinese economy.

By **Christine Miles** (Gide Beijing), French Foreign Trade Advisor for Mainland China, and **Li Siyue** (Gide Beijing)