Reform of China SOEs

Reform of state-owned enterprises (SOE) in China has gathered pace since the third plenum last November. The four pilot reform programmes announced by State-owned Assets Supervision and Administration Commission (SASAC) last month indicate China’s commitment to advance SOE reform, which should help improve SOEs’ operational efficiency, corporate governance and earnings outlooks. SOE reforms will continue to be the market focus for the rest of 2014.

LATEST DEVELOPMENTS OF SOE REFORMS

Despite having contributed to China’s fast economic growth for three decades, poor efficiency, high debt ratios and bureaucracy at SOEs represent a challenge to China’s economic development today. The unbalanced allocation of resources between SOEs and the private sector has become a more debated issue during the economic slowdown. Supported by the Chinese leadership’s commitment, a new round of SOE reform has accelerated in the past year.

On July 15, SASAC, the supervisory body for SOEs in China, announced that six SOEs had been chosen to participate in four pilot reform programmes.

Four pilot programmes

<table>
<thead>
<tr>
<th>Establishing state-owned capital investment companies</th>
<th>Developing mixed ownership structure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pilot SOEs:</strong> China National Cereals, Oils and Foodstuffs Corp (COFCO), State Development &amp; Investment Corp (SDIC)</td>
<td><strong>Pilot SOE:</strong> China National Building Materials Group (CNBMG), China National Pharmaceutical Group Corporation (Sinopharm)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Granting authority for board of directors to hire, evaluate and compensate senior managers</th>
<th>Sending disciplinary inspection teams into central SOEs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pilot SOEs:</strong> CNBMG, Sinopharm, China Energy Conservation and Environment Protection Group (CECEPG), Xinxing Cathay International Group (XCIG)</td>
<td></td>
</tr>
</tbody>
</table>

The reform of the selected pilot SOEs is a concrete step since the third plenum last November, when the SOE reforms were announced. The pilot programmes led by SASAC help to translate the government’s reform agenda into actions and pave the way for reforms to be carried out on a larger scale.

At the third plenum, the top leadership vowed to redefine the relationship between government and markets, and let the latter play a “decisive role” in allocating resources by creating a level playing field for both SOEs and private enterprises. According to the Communiqué, some SOEs would phase out from competitive sectors and create room for private companies; government function of SOEs should be separated from enterprise management and a number of state-owned capital investment companies would be established. (see below for a more detailed explanation of what these are and how they will be a positive development)

The 2014 government work report, delivered by Premier Li Keqiang in March, reiterates the goals of SOE reform, such as the development of mixed-ownership
structure and the establishment of sound modern corporate structure and corporate governance in the state-owned sector. Li also noted that non-state capital would be allowed to participate in projects in areas such as banking, oil, electricity, railway, telecommunications, resources development and public utilities.

**IMPLICATIONS OF PILOT PROGRAMMES**

The implications of the pilot programmes are more profound and far-reaching than the rally in the shares of the chosen SOEs and subsidiaries listed on the Chinese and Hong Kong markets suggests. Overseeing 113 central SOEs, SASAC is using the six pilot SOEs to implement its reform programmes and then will promote the good practices and experiences learned on a wider scale and expand the scope of its reform programme.

Founded in 2003, SASAC took ownership of the last round of SOE reform. It integrated the responsibilities of supervising and managing SOEs from a host of government agencies including State Economic and Trade Commission, former CPC Enterprise Work Commission, the Ministry of Finance and the Ministry of Labor and Social Security. At the enterprise operation level, it helped to reinforce the management of the state-owned assets, promote the establishment of modern enterprise system in SOEs, and improve corporate governance. It also manages the supervisory board of large enterprises on behalf of the state, and appoints, removes and evaluates the executives.

Over time, the centralised administrative intervention has helped SOEs develop more rapidly and many have become strong players in key sectors and Global 500 firms. However, today, by acting both as the shareholder and the regulator of state-owned assets, SASAC’s excessive administrative intervention has restrained the autonomy, innovation and development of SOEs. A new round of reform is needed for SASAC to reduce its influence and grant SOEs the authority they need to make further progress.

**Pilot Scheme 1: Establishing State Owned Capital Investment Companies**

Under the pilot scheme of establishing state-owned capital investment companies, SDIC and COFCO will hold ownership rights of SOEs on behalf of SASAC, and serve national strategic interests by improving the efficiency of state-owned capital operations. In the meantime, SASAC will only scrutinise the state-owned capital investment companies, and hence, its primary functions will be changed from running SOEs to pure capital management. This is a step forward towards the separation of SASAC’s dual roles.

**Pilot Scheme 2: Board Authority To Hire And Compensate Management**

The board management reform will give SOEs more autonomy to appoint senior executives and compensate them according to performance. This measure will help to clarify the duties of SASAC as a supervisor and the autonomous decision-making function of the management board, and thus optimise SOEs’ corporate governance. Therefore SOE management’s interests will become aligned with the business goals of the company and the interests of shareholders.

**Pilot Scheme 3: Developing Mixed Ownership Structures**

After the global financial crisis in 2008, while SOEs’ dominance and even monopoly have increased in key sectors, their efficiency have been decreasing but debt ratios have climbed up. SOEs’ ROE has steadily fallen since 2008, and the government’s “four-trillion stimulus” package has caused leverage ratios of SOEs increase significantly as they tend to have better access to bank financing than private companies. From 1996 to 2013, ROE among SOEs is inversely correlated with the percentage of state-owned equity.

“The Government’s reform agenda, including SOE reform, is the new stimulus for China, with anti-corruption the new austerity.”
Jing Ning, portfolio manager, FF China Focus Fund

“Any new stimulus is expected to carry a reforms hat.”
Jing Ning, portfolio manager, FF China Focus Fund
Correlation between ROEs of listed SOEs and shares of state-owned equity

Source: FIL Limited, Goldman Sachs, Wind, June 2014

This indicates reforms by attracting more private equity participation are likely to improve SOE efficiency. The pilot plan of developing mixed ownership is a market-based methodology to enhance efficiency and profitability by inviting private-sector capital. The reform is not only positive for SOEs’ earnings outlook, but also meaningful in terms of supporting China’s GDP growth especially at the time of economic slowdown. The programme introduces management and employee ownership to improve corporate governance by establishing efficient checks and balances and equal protection of all shareholders.

While some commentators may be concerned the depth and scale of SASAC’s trial reforms do not fully match the commitment made by the central government at the third plenum, investors need to understand that SOE reform has been a complex ongoing process ever since China embarked on the journey of reform and opening up of their economy in 1978. This solid step forward is positive for the state-owned sector and China’s overall economic development. As reforms progress, the participation of private enterprises in the economy will increase especially in the government-protected industries, and the interests of management and shareholders’ will become more aligned. Meanwhile, the anti-corruption campaign is also improving the ROE of SOEs by reducing actions such as leakage through bribery, giving contracts and favourable prices to related entities.

China SOE reform – the history and future

"SOE reform is a crucial part of the overall reform agenda. SOE turnaround will be achieved by promoting SOE ownership structures, improving SOE performance and enhancing management incentive schemes.”

Jing Ning, portfolio manager, FF China Focus Fund

Source: Source: FIL Limited, CICC, Goldman Sachs, Media reports
While SASAC has chosen six SOEs for the pilot programmes, a larger scale of reform has actually taken place in the past year in some sectors dominated by state-owned players. One example is the oil and gas industry which is gradually opening up to private capital.

In the upstream exploration segment, the participation of private companies has been low, with only four companies certified for oil exploration and production (E&P) work in China, namely PetroChina, Sinopec, CNOOC and Yanchang Petroleum. Going forward, the central government will issue more licenses and the upstream segment will be more open to private enterprises. For instance, PetroChina is in the process of stake sales in upstream assets and seeking external partners for E&P projects. Potential candidates can be local enterprises, private companies, investment platforms of local government and asset management companies.

In May, PetroChina has also announced it will transfer the assets and liabilities of the First and Second West-East Gas Pipeline to a new entity, PetroChina Eastern Pipelines Co., Ltd. The holdings of the new entity will be sold through a public tender on an equity exchange. The net asset value of the pipelines was appraised at about RMB 39 billion (USD6.3 billion).

The goal of mixed ownership reform in the energy sector is to change the nature of oil and gas from national strategic assets back to pure commodities, allowing the pricing regime become more transparent. Therefore, the downstream distribution segment is also being opened up for non-state owned players.

Sinopec, owning more than 30,000 gas stations in China, is selling up to 30% of its retail unit, Sinopec Sales, to social and private capital. As the total assets of the retail business unit, as of the end of April, is RMB 342 billion, the sale is likely to raise approximately RMB 100 billion (USD16 billion). In its filing on June 30, Sinopec stated that it would prefer domestic candidates and players in the same industry who can complement the business and bring benefit to the broader Chinese public.

This initiative of Sinopec's is to speed up development of mixed-ownership, while improving market-oriented operation and management control. The company aims to become a comprehensive and integrated service provider in the future and expand into new businesses including convenience retailing, car services, telematics, Online to Offline (O2O), financial services and advertising.

While still maintaining control over national strategic assets, the development of mixed ownership in the energy sector not only promotes higher private-sector participation, but also helps to boost innovation and unlock the value of SOEs.

Additionally there are initiatives taken towards creating market-based pricing system in water, telecoms, and power. These price reforms are positive to the new entrants from private sectors and the overall economy.
References


3. SASAC

4. SASAC


7. Caixin, March 7, 2014, 周吉平：中石油向民资开放上游勘探开发


9. Sinopec Said to Seek $16 Billion From Investors for Retail Unit, Bloomberg, July 24 2014


Important Information

This document is provided for information purposes only.

Fidelity only gives information about its products and services. Investment involves risks. Any person considering an investment should seek independent advice on the suitability or otherwise of a particular investment. Fidelity is not authorised to raise, distribute or manage mutual funds or the relevant products in, or to provide securities investment management or advisory services to persons resident in, the mainland China.

FIL Limited and its subsidiaries are commonly referred to as Fidelity or Fidelity Worldwide Investment. Fidelity, Fidelity Worldwide Investment, the Fidelity Worldwide Investment logo and F symbol are trademarks of FIL Limited.

CM20140815F