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thequarterlydragon #3

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«SOEs: the low-hanging fruit in China's economic reform process?»

Private companies provide most of the momentum of China's economy today. Estimates are that 26% of China's industrial output is generated by state-owned enterprises (SOEs), down from 55% in 1990. The majority of new jobs in urban centers in China are generated by private companies. So why write about SOEs?

Many of them provide excellent services, e. g. telecom companies, but many are hopelessly inefficient. Reforming them would provide a significant boost to China's economic dynamics. And from an investor's point of view, China's SOEs also are very important:

- the main stock market indices comprise an exposure to SOEs of over 50%
- SOEs continue to dominate important economic sectors such as telecom, finance, energy, health care services, transportation, aviation and mining
- SOEs absorb many of the country's financial resources at below-market prices, but often use them inefficiently and thus have contributed to the economic slowdown and intensified financial repression.

Renewed, recent announcements regarding SOE reform make clear that:

- the government will not systematically retreat from the markets
- SOEs will remain powerful in many sectors of the economy
- operating in the China market will not become easier for private companies, at least not in the near future
- state-run companies will become more active abroad in search of acquisitions of technology and know-how

SOEs represent the majority of China A-share equity indices

When you buy A-shares via an investment product that closely reflects an A-share index, you are likely to buy a lot of SOE exposure. This, per se, is neither good nor bad, but it is something to be aware of. The large, well-known indices do not really represent the current economy and its full growth potential. More than half of the market capitalization in MSCI China is accounted for by SOEs. And state-owned companies made up the following percentages of all the companies listed on the Shanghai stock exchange:

SOEs among Shanghai-listed companies ❶

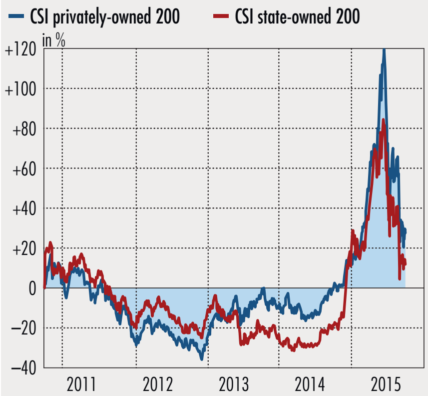
	SOEs	SOEs as a % of total
Number of companies	664	61.98
Market capitalization	RMB 20.43 trillion	81.37
Revenues	RMB 20.92 trillion	90.86
Net profits	RMB 1.86 trillion	90.39

Data as of December 31, 2014

Source: www.stcn.com/2015/0508/12228811.shtml.

The fact that buying SOE exposure does not have to be bad is illustrated by chart #2, which compares an index of the 200 largest privately owned entities listed in Shanghai or Shenzhen (CSI POEs 200) with an index containing the 200 largest central and local state-owned enterprises (CSI SOEs 200). The history over the last five years saw periods of outperformance for each index.

Similar performance pattern ❷



Source: Bloomberg / Chart: ChinaIntelligence

Do SOEs have a chance to succeed and their shares to perform well in the future? Absolutely. Innovations from SOEs will be incremental rather than disruptive; they may exhibit traits of sclerosis and corruption and sometimes are forced to pursue goals other than the ones a shareholder value activist dreams of. But their market position is strong in many instances, the government's policy support can be taken for granted, their access to financing is good and they have a steady supply of talent choosing them as employers (see below). «SOE reform» is one of the themes some investors focus on when seeking exposure to Chinese equities, given their belief in change and the low valuations (e.g. SOEs trading at 0.9x their 12-month forward Price / Book Value in the H-share market according to UBS Securities China).

SOEs in China's economy today

«All you can do as a private company in China is find a niche between the vast business areas covered by SOEs and try your best to be successful in that niche. Trying to build a private business inside a business area in which SOEs are widespread is futile.» This is what the founder and CEO of a private business once told me when I asked him how he came to define the business area for his company the way he did. He started his company in the early 2000s and China has changed since then, but even today his statement probably is only a slight exaggeration.

China has come a long way since allowing private ownership of enterprises on a large scale in the 1980s. Nevertheless, with an approximate 26% of the output value in the manufacturing sector coming from SOEs[1], China still ranks among the economies with the highest contribution by the state. In addition, SOEs are important employers. What proportion of the workforce is employed by them is not easy to define because the official statistics deliver a lot of different employment categories. Estimates are that in urban areas, between 20% and 30% of employees have a link to state-owned enterprises.

The market share of SOEs is very different from sector to sector, and not all the sectors SOEs are active in can be considered having strategic importance to China. Their strong presence in sectors providing basic infrastructure including air transportation, financial services and telecommunications comes as no surprise. But the state is also present in many other significant sectors. Some state-owned groups, like Huarun and CITIC, have dozens of subsidiaries and are fully horizontally integrated. Their business covers all kinds of industries you can imagine. Thus, they have good resistance to risk and a great influence on the markets.

Many of the state-owned companies provide excellent services to their customers, e.g. the telecom companies. Advanced networks handle the immense voice and data traffic around the clock very well; also at 3 a.m. on any given day more than a hundred million Chinese are online. Mobile phone reception is excellent, even in the remote areas of Western China. And if there is a problem with the Internet connection at home and you call the service hotline, the question is not in how many days or weeks the repairman will show up – as in some «developed» countries. He will be at your door within two hours, fixing the issue and leaving his personal phone number in case there are further problems.

What keeps the SOEs strong?

Most of the estimated 155,000 state-controlled companies are held by the local governments. Currently 111 SOEs are managed by SASAC (the State-Owned Assets Supervision and Administration Commission), other large companies or conglomerates are controlled by central government ministries (see chart #3). Thus very many entities throughout the country have responsibilities for, rights to and benefits from state-owned assets, which immediately makes one aspect clear: A uniform approach to handling these vast and valuable assets is difficult to implement.

That state-owned companies have good bargaining power in their markets, receive more protection from the government and can obtain financing at attractive rates, is obvious. The dominant shareholder (i.e. the government) is looking out for its interests.

Less obvious is the interesting fact that among university graduates, SOEs still are seen as very desirable employers. This may lead to a continued flow of talented people to the state-run companies and support reform efforts. It can also be seen as one of the reasons why SOEs are not only here to stay but also may continue to play a forceful role in China's economy.

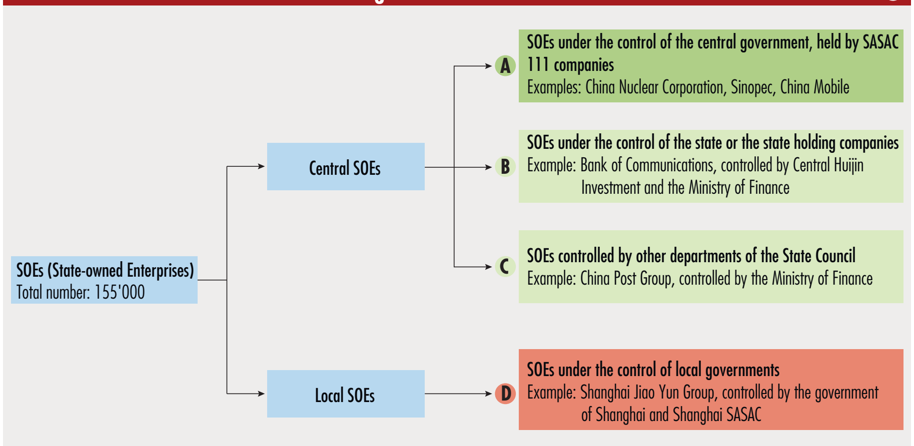
Gossip suggests that China's brightest students want to go to work abroad, and those who can't for some reason want to work for a foreign employer in China. As we always attempt to stay as close to the facts as possible, we want to base our view on actual numbers such as surveys of university graduates taken.

A recent survey[2] shows that a total of 64.4% of 2015's university graduates wanted to go to work for a state-run entity:

- 36.5% of the university graduates want to go to work for an SOE
- 17.5% want to go to work for a public institution
- 10.4% want to go to work in government administration

But because these desired jobs are limited and normally accessible only after passing a rigorous exam, in reality, 72.7% of the graduates ended up going to work for private enterprises.

How the government holds its assets 3



Source: SASAC (state-owned Assets Supervision and Administration Commission) / Grafic: ChinaIntelligence

[1] Source: Statistical Yearbook of China, and Nicholas R. Lardy, Markets over Mao, 2014.
[2] Survey conducted in all of China by the School of Journalism and Communication of the Beijing University and Ganji.com, source: http://edu.sina.com.cn/gaokao/2015-08-22/1559481713.shtml.

SOEs are politically and socially sensitive

Employment by the government has declined substantially in the last 20 years. It still is relatively high in manufacturing, less so in other sectors (for examples, see chart #4).

But for historical reasons, many state firms are the dominant employers in their local areas. Because they were distributed across the country during the times of the plan economy and because they have been around for many decades, large groups of people have come to depend on them. In many provinces, a high percentage of employees work for SOEs. **Therefore, the restructuring of such enterprises is politically and socially sensitive, because the respective companies often are one of the few employers in their areas.**

When considering the topic of SOE restructuring, it is crucial to bear in mind that the growth differential between different provinces is very big. Some do not grow, such as the «rust belt» provinces in the Northeast, while others continue to grow at double-digit rates. If you reduce the headcount of state-controlled companies in large metropolitan areas with economic growth above the national average, chances are that other employers will pick up the employees. **In some provinces with economic growth below the national average, however, there are few employment alternatives.** Closing a factory in such an area almost inevitably sends the former employees back to the farms – a development understandably perceived as a step back and thus carefully avoided by the government if at all possible. This is one reason why **state-owned companies will continue to exist for a long time, in some cases no matter how hopeless their economic perspectives are.** Social stability and employment are more important policy objectives than efficiency. But if the efficiency were to improve only marginally, the effect could be felt nonetheless.

Declining SOE employment (4)

The changing sectoral and ownership distribution of the corporate sector 1980 to 2012 (by employment)

Ownership	1980	1992	1997[1]	2003	2012[2]
Manufacturing					
SOEs in %	70.0	63.9	65.0	37.6	26.1
Collectives in %	30.0	28.1	21.4	8.4	1.3
Others in %	0	8.1	13.6	54.0	72.6
Construction					
SOEs in %	49.0	58.9	39.4	21.7	10.7
Collectives in %	51.0	41.2	54.6	20.9	5.1
Others in %	0	0	5.9	57.4	84.2
Trade and distribution[3]					
SOEs in %	30.4	17.9	21.5	27.5	9.7
Collectives in %	62.2	30.2	17.1	6.0	0.9
Others in %	7.5	51.9	55.4	66.5	89.4

[1] For Trade and distribution, 1996 figures have been used.
[2] In the manufacturing sector, no employment data are available for 2012. The distribution is based on operating revenues.
[3] Includes mainly retail and wholesale trade, accommodation and catering.

Note: The category SOEs includes «people-owned enterprises» in the beginning of the period and «state owned and state holding» in the latter part. The category Others includes foreign-owned, private Chinese ownership and companies with mixed or undisclosed ownership.

Source: OECD 2015, state-owned enterprises in the development process

Recently outlined courses of action for SOE reform

An announcement in September 2015 by China's State Council relit the fire under SOE reform. The profitability of SOEs has declined: By some measures, they are less profitable than private firms. Some of the large, prominent SOEs in the steel and shipbuilding sectors are cash burners. **The large, well-known SOEs, listed on a stock exchange and serving as examples of technologically advanced companies, are not the norm but the exception.**

The topic of SOE reform is not new, and much has been achieved over the last decades. During the reforms in the 1990s, small and mid-sized state-owned companies were privatized or closed, and large ones were changed radically. This process culminated in the international stock exchange listing of some of the largest companies, including commercial banks and telecommunication companies. As a result of this process, tens of millions of former state-firm employees lost their jobs. The total number of SOEs declined from approximately 260'000 in 1997 to approximately 115'000 today. The number of central SOEs declined from 196 in 2003 to 111 today. This is one example of **the government's (sometimes) strong resolve to make uncomfortable decisions.**

But much has also been put off, including the big push in 2005 to reform SOEs, which did not gain much traction in an economy growing at 10%+ annually. Powerful interest groups do not want the status quo to change. So any announcement regarding SOE reform has to be taken with a grain of salt; **progress will not be immediate, but gradual.**

Bigger motivation to act this time?

So what is different this time? **The weaker economic growth rates may make the need for continued improvement of a large part of the economy more urgent and may provide incentives to act.** We will see. In the meantime, it is worth summarizing the general direction of the recent announcements:

- All SOEs will be classified as either playing a predominantly social role or a predominantly commercial role. The government's influence in the former is expected to remain high.
- The government envisions a shift of its role from managing enterprises to managing capital.
- The concept of «mixed ownership» shall be pursued, to include private investors and making employees shareholders; however, **full-scale privatizations appear unlikely.**
- Efficiency improvements, including consolidation of SOEs, shall continue, but the elimination of monopolistic market positions for SOEs appears unlikely.
- Increasing accountability and improving supervision is an objective once again.
- Changes towards a more market-based compensation system will continue.

This will probably lead to a minority position for the state in some SOEs. **The government will leave some sectors,** possibly also through bankruptcies and closures of companies. And we already have started to see some mergers, like in the railway equipment sectors (merger of the listed companies CNR and CSR), in the nuclear sector and in aluminum production (where Aluminum Corp of China took over the aluminum smelters from a different energy company). In other areas of the mining sector, such as rare earth metals and gold, more than a thousand companies have been closed or merged, not least due to stricter environmental requirements.

The developments for different companies will be influenced partially by the sector they operate in. Industries like basic utilities for water and electricity, energy, transportation and telecommunications are considered **strategically** important and will remain in the government's hand. In industries considered as **basic sectors,** the government intends to hand over part of the control of companies: automotive, IT, machine manufacturing, construction, chemicals are some of them. In industries like trade, medical services, agricultural products and construction materials, labeled **competitive sectors,** the state can hand over control to other shareholders.

Nothing radical, nothing entirely new. The news is in the emphasis of the different measures, and the key is in the forcefulness of the implementation. No miracles will happen, but action would be rewarded with a significant impact on the economy.

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Last but not least: SOEs vs. private companies

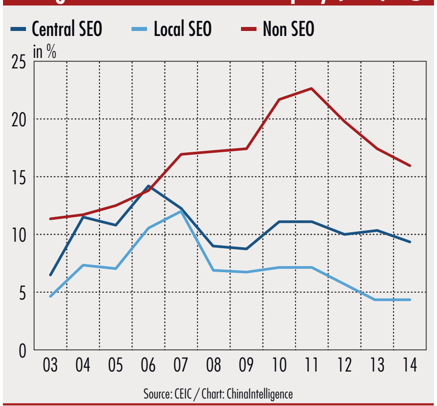
When comparing private and government-controlled companies in China, formal ownership is the delineating factor. Beyond that, however, and more than in many other countries, all companies need to respect the enormous power of the government on all levels in China and thus need to bear in mind the government's wishes in everything they do.

When you are used to spending time in the factories of privately owned, cash-strapped companies and then you visit a plant of an SOE in the same industry, you feel like stepping out of an under-resourced neighborhood in Los Angeles directly into Disneyland: Everything is shiny, the showroom uses the newest technology equipment in abundance, the coat of paint on every building looks like it was applied just last year, and the canteen actually looks appealing. It is obvious that there is enough money to also take care of the non-essential things.

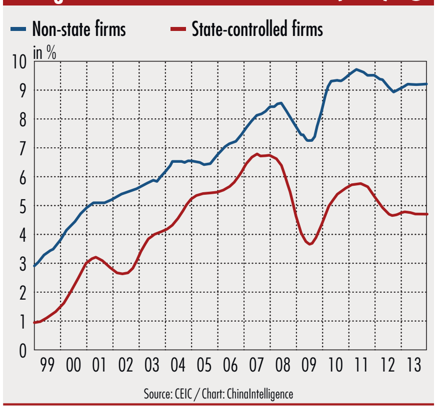
So what is the financial performance of state-run companies compared to the private sector? We probably cannot know. But a few statistics are available, which have to be read with even more caution than other numbers from China. Charts #5 to #7 show some standard measures of efficiency for companies. Two seem to confirm what intuition and economic theory suggest, namely that private companies are more profitable than SOEs (ROA and ROE). Profit margins (chart #7), however, show no consistent difference.

When comparing the performance of state-run and private companies, the return on assets is the comparison mentioned most often. This may or may not provide meaningful numbers since the SOEs have huge assets because most of them have roots in manufacturing. The Chinese obsession with assets (as opposed to a focus on cash flows) probably led to a reluctance to write these assets down. In addition, assets are useful when justifying to the banks why loans should be extended. So the SOEs assets may be overstated, leading to lower returns on assets than if the assets were handled the same way as in private companies. Overall, the profitability of the two groups of companies may be more similar than usually assumed and may express the many difficulties private companies face when operating in China: ferocious competition, corruption, a legal system that relies too much on persons as opposed to relying on legal norms, administrative hurdles and high interest rates. Against this background, the CEO mentioned at the beginning stated: «The question is not what hinders the private sector in China. The question is why there are successful private companies in China at all.»

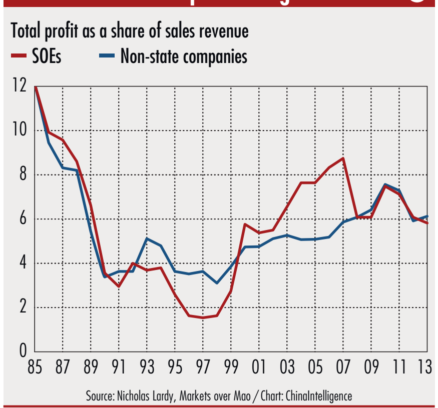
Big difference in return on equity (ROE) 5



Big difference in return on assets (ROA) 6



Similar profit margins 7



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