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ZURICH

A New Dawn for China's SOEs

Deleveraging and reform breathe life into a critical sector

China has been promising reform of its state owned enterprises (SOEs) since the nineties without much progress. Now there are signs that the government is pushing harder to get rid of zombie companies, fostering mixed ownership schemes and tackling debt deleveraging. The latest developments are encouraging and should help to make SOEs more efficient, even though the road will remain bumpy.

Source: iStock

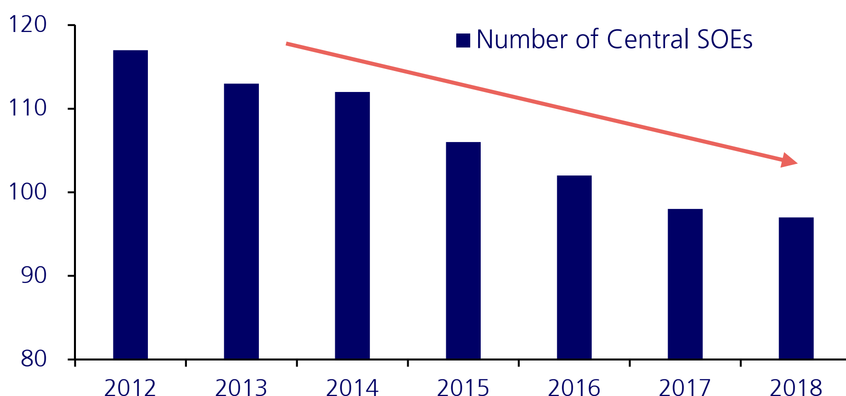
Deleveraging remains a core target for the government

Debt deleveraging has become a core target for China's government, confirmed at the National People's Congress in March this year. In his ground breaking speech at the Davos Forum in January, Vice Premier Liu said that China needs to tackle systemic risks and bring macro leverage under control by 2020. A month earlier, the Central Economic Work Conference had defined China's 'three battles', namely defusing financial risks, poverty alleviation and pollution control. Amongst these three policy goals, the first was highlighted as the most important one. Drastic action to rein in financial irregularities and shadow banking excesses has since been taken. From May to July, shadow banking was curtailed dramatically, with dire consequences for credit access particularly for small and medium sized companies (SMEs).

The sudden slowdown in China's economy in Q2 has been the result of over-tightening, and shows the need for some fine tuning and re-interpretation of specific targets. However, both the State Council and the Politburo made it clear in July that the deleveraging target per se remains in place.

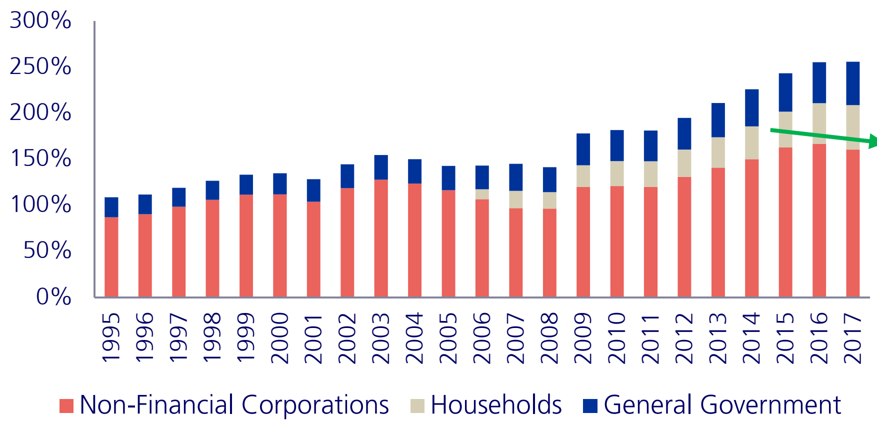
Even though external debt in foreign currency has increased, China does not have an external debt problem, but rather a domestic one, which again needs to be distinguished. Central government debt is not the issue, and even though mortgage loans have doubled within the last three years due to the property market boom, household debt is still manageable. That leaves local government and corporate debt as the core problem. Within the corporate sector, the main problem is the debt load of state owned enterprises (SOEs), as private industrial companies have already de-levered. Were SOEs to run into trouble, it is believed that the government would ultimately step in by taking over the bad debt load, but China's government has decided to tackle the problem before it escalates, and is not willing to guarantee SOE debt explicitly. Earlier this year, a specific debt-reduction target of 2ppts for the liability/asset ratio of SOEs, which is now at 66.3%, was formulated, while the regulatory ceiling was lowered by 5ppts. Notably, no specific targets were set for a nation-wide leverage ratio as the overall policy directive is stabilisation rather than a reduction.

Downsizing



Source: SASAC

Corporate debt is no longer rising



Source: BIS; (salmon coloured bar includes household debt from 1995-2005)

SOEs play an important role

SOE statistics are indeed impressive: Estimates about the number of China's SOEs at the central, provincial and city level range from 133,000 to 167,000, accounting for about a quarter of China's industrial assets and employing 18% of urban employees. Though this sounds significant, the share of SOE total industrial assets has tumbled from nearly 70% twenty years ago, and from 60% in terms of employment. But that doesn't mean that the SOEs are redundant. Indeed, over the last ten years, assets of non-financial SOEs have grown significantly, reaching RMB 173tn, or 209% of GDP. This expansion has been mainly funded by debt, with the debt-to-equity ratio of central SOEs soaring from about 150% ten years ago to now 211%.

Debt and leverage of China's economy has become a headache for the government. Non-financial-corporate debt, at 160% of GDP, has become a worry. SOE debt makes up about 62% of that, which brings SOE debt to about 100% of GDP. It seems that the authorities have realised that the corporate debt problem is an obstacle for the country's long-term development.

SOE reform is gaining speed

SOE reform became a political target in the nineties, and re-emerged as a topic in 2016 when ten types of SOE reform pilots were launched, but has only been tackled with vigour since last year. An important SOE reform document was published by the State Council in early May last year, focussing on the new corporate governance structure of SOEs. By 2020, SOEs are expected to run their businesses independently. SASAC, the State-Owned Asset Supervision and Administration Commission, announced that it will no longer be responsible for managing SOEs, but rather function as a regulator and investor. 43 regulations will be simplified or completely revoked. SOEs will have the right to appoint independent managers, with the general manager appointed by the board of directors, and SOEs will be allowed to set their own KPIs and incentive structures. Finally, the State Council announced the reform plan for the oil and gas industry, encouraging competition and reforming the oil pricing mechanism.

Last summer, the 5th National Financial Work Conference, which is held every five years, set the tone. Deleveraging the economy to prevent systemic risk was the main topic. SOE reform was singled out as a core target for deleveraging, acknowledging the need to force so called 'zombie companies' to exit the market. Local government debt was also a topic, as it had nearly doubled to 50% of GDP within the last ten years. Both Premier Li and President Xi called for more progress on structural reform.

To put the progress of accelerating supply-side reforms in numbers, last year SOEs were restructured by cutting the number of legal entities in centrally-owned SOEs by about 8,400 and by shutting down 1,200 loss-making 'zombie' firms, resulting in cost reductions of more than RMB 150bn.

About two-thirds of centrally-owned SOE assets are in listed companies, which generate 80% of SOE profits. These firms are being encouraged to improve transparency and communication with investors. SOEs are now required to focus on their core business, while investments in high leverage projects will be prohibited. Firms need to use part of their profits to reduce debt. Debt/equity swaps shall be advanced further. Generating losses and increasing debt will be punished. Historically, SOE managers had privileged access to funds and resources and were promoted when they contributed to China's growth. Now they will be punished if they increase debt. Will this pressure make them better managers or change their mindset? Probably not immediately, but over time, particularly if incentives are implemented in the right direction and if assistance by private managers is accepted and promoted, progress should be visible. It would certainly be better to gradually remove implicit guarantees and improve corporate governance, instead of fostering tighter government control. We accept that in China's recent history, major structural changes would not have happened without tight control by the Communist Party and the central government. President Xi's anti-corruption campaign may serve as an example.

The latest development is a pilot program to separate ownership and operations of SOEs. The Chairman of the Board will be nominated by the Communist Party. While the Chairman cannot take over the role of the CEO at the same time, major decisions will still be taken by the Communist Party, not the CEO, which needs to be watched.

Mixed ownership reform in focus

'Mixed-ownership' is an important ingredient for SOE reform, even though it was already in policy guidelines issued three years ago. The idea is that private management expertise will help to diminish the profitability gap between private and state-run companies, without giving up complete control by government bodies. A shareholding structure and a board of directors will be incorporated for all large, central government-owned SOEs and their subsidiaries.

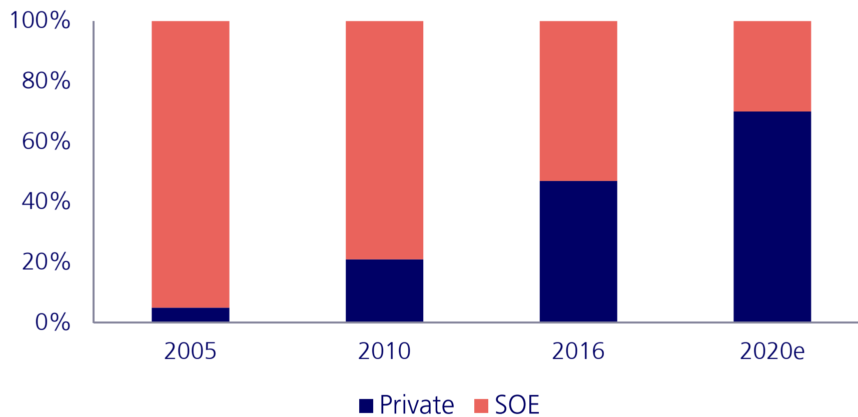
A pilot programme for mixed ownership reform in the telecom sector started in mid-August last year when state owned Unicom Group announced the reduction of its equity stake in Shanghai listed China Unicom, the weakest major telecom operator in terms of profitability, from 62.7% to 36.7%. New strategic shareholders will include other state owned entities as well as private non-financial companies, such as the well-known internet giants Tencent, JD, Alibaba and Baidu, as well as industrial companies. 2.7% of shares will be allocated to employees in the form of stock options, though vesting will be highly regulated, while management will receive a small portion as an incentive. Within a year, more than one hundred listed SOEs launched plans for employee ownership, with those in Beijing and Shanghai being most advanced.

It is worth noting, however, that state owned entities still control more than half of total equity capital. China Unicom is the first of nine centrally owned SOEs that are part of the first batch of a pilot programme. The mixed ownership announcement for China Eastern Airline Logistics is another example that also exceeded expectations.

Even though SOE mixed ownership reform seems to be slow, we expect more announcements from the first batch of nine pilot SOEs, including China Nuclear, China State Shipbuilding, Southern Power Grid and Harbin Electric. China Eastern Airline has already completed the reform for its logistics business, and has submitted a reform plan for the whole company to the regulator. Authorities have already approved the ten candidates for the second batch of pilot SOEs, which are now in the implementation stage. It is interesting to note that military and national defence related companies will also be affected by the mixed ownership programme. We expect the approach to broaden out to SOEs on a provincial level.

Many provinces have already published guidance on mixed ownership reform, and we also expect SOEs to take stakes in private companies. SOE Shenzen Metro's stake in Vanke, a major private property developer, comes to mind, even though we recognize that this may be have been a special case to fend off a takeover battle. Anbang Insurance and Hainan Airline may follow. Going forward, even foreign investors are expected to be allowed to participate in mixed ownership offers.

Composition of MSCI China is no longer dominated by SOEs



Source: NBS, Morgan Stanley

The inclusion of a 5% portion of 'A'-shares to the MSCI index family is a good start and more Stock Connect schemes are in the offing.

What is the incentive for a modern and efficient high-tech internet company to take a stake in an SOE? We believe this has to be seen in the context of a mutual agreement between China's government and the private sector. Competent managers from companies like Tencent or Alibaba may bring their managerial skills to the SOEs. While managers from private companies are not forced by the authorities to bring their skills to SOEs, they want to maintain a good relationship with the government and help the reform agenda move forward.

Consolidation, scrapping capacity and tackling 'zombie'-companies is key

Consolidation is another major pillar of SOE reform, particularly in the power sector. In August 2017, President Xi approved the merger of China's biggest coal mining company, Shenhua Group, with the major power generator China Guodian, creating the world's largest power company. The new company, China Energy Investment, has an installed capacity that exceeds the combined capacity of French generator EDF and Itay's Enel. The merger should contribute to the government's target of cutting industrial capacity and fostering the use of clean energy. Pure coal generators have to compete in liberalised wholesale markets. China Huaneng and State Power Investment, as well as China Huadian and China Datang, are believed to be the next major state power generators that will merge.

Excess capacity reduction is progressing. While coal capacity was cut by nearly 300 million tons last year, the steel industry has contributed with a 65 million ton capacity reduction, with more to come. Loss making and non-core businesses have been spun off or shut down, helping to improve SOE efficiency. SOEs have also disposed of bad assets by selling them to China's top four AMCs (asset management companies) Cinda, Huarong, Great Wall and Orient AM, as well as some regional players that are bidding for toxic assets.

Two arguments have often been brought forward against SOE reform on a local government level. Firstly, vested interests by local authorities are standing in the way of reform. Here we note that the central government has pushed hard for local authorities to obey, or face negative consequences. Secondly, laying off workers while reducing capacity or closing inefficient local plants, which in the case of the power industries makes up 40% of the total, could result in unrest and become a risk for the Communist Party.

Labour market implications are tackled

These risks have been taken seriously, with the central government helping to relocate discharged coal and steel industry workers in the most affected provinces, Shanxi, Henan and Hunan. The government has also budgeted RMB 100bn per year for labour resettlement programs. It has to be noted that sectors linked to overcapacity make up only 8% of total employment, which seems manageable if phased out over several years. Many workers will also be absorbed by the booming service sector, which contributes to an overall tight labour market.

Crossing the river by feeling the stones

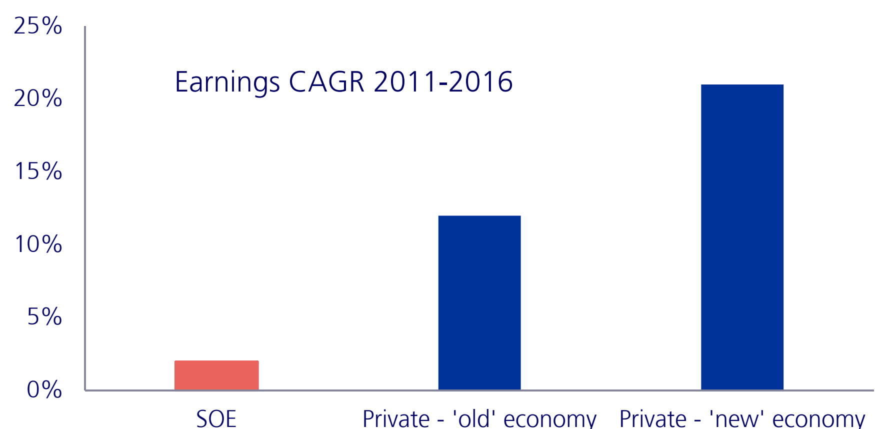
The famous saying by Deng Xiaoping "Crossing the river by feeling the stones" aptly describes the process of SOE reform. Certainly there will not be an immediate change in culture and in the way of doing business overnight, but we believe both central government pressure and cooperation with efficient, entrepreneurial private companies will bring many SOEs on the right track. Those that are not willing or able to change and remain 'zombies' are likely to be dissolved.

Miracles cannot be expected. SOEs will find it difficult to achieve levels of productivity common to private companies, especially those in the so called 'new' economy. But SOE reform is expected to contribute to an improvement in productivity and will build both domestic and foreign investor confidence.

SOEs no longer have the dominance in China's equity market they used to have. Even at the start of this decade the capitalisation of the MSCI China index was made up of about 80% SOEs. Today, despite the recent severe stock price correction, the six main internet related companies already have a weight of one third of the index, the main benchmark for institutional foreign investors, with Tencent and Alibaba alone having a weight of more than one quarter.

Consequently we remain optimistic on the changes that are underway. SOE reform is crucial to bringing China towards its long-term target formulated in its 'China 2025' programme. Questions remain, however, about the willingness for a change in mindset at SOEs, and about the degree of Communist Party involvement in management. Our stance remains 'trust, but verify'.

SOEs are less productive than modern private companies



Source: FactSet, Macquarie

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