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07/26/2006

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China: Reform from the Outside In

Beijing is selling off ownership stakes in its state-owned companies. The goal isn't capital; it's transparency.

Foreign companies are in the midst of an extraordinary shopping spree in China. In October 2005, Carlyle Group became the first direct buyer of a Chinese state-owned enterprise (SOE), with its $375 million bid for an 85 percent stake in Xugong Group Construction, the country's largest construction machinery manufacturer and distributor. That deal was quickly followed by a handful of other high-profile foreign bids for Chinese SOEs, including the January 2006 announcement that Goldman Sachs, Allianz Group of Germany, and American Express would pay $3.8 billion for a minority stake in Industrial and Commercial Bank of China, the country's largest government-owned bank.

The big news is not that foreign companies are investing in Chinese firms; this has been going on, mainly through joint ventures, for some 15 years. What makes the latest wave of deals so unusual is that for the first time the Chinese government is offering outsiders ownership positions in its thousands of state-owned enterprises. The shift is an unmistakable signal that China has made reform at its biggest companies a top priority. No longer silent partners, foreign investors will be in a position to bring new management approaches, better incentive systems, greater transparency, and a whole new level of corporate governance. "This is not merely a transactional process, but a starting point for deep change," says Edward Tse, managing director of Greater China for Booz Allen Hamilton.

Indeed, the Chinese government's sale of SOEs is not about gaining access to foreign capital. Marshall Meyer, professor of management at Wharton, points to China's $800 billion in foreign reserves to make that point. "China doesn't need the money," says Meyer. "For them, it's secondary." Rather, China's move is aimed at importing Western business expertise. Quickly moving state-owned firms to sound commercial footing, says Professor Meyer, requires not just cash but experience. Once a firm becomes a shareholding company rather than a wholly state-owned enterprise, it is required by Chinese securities law to install directors and corporate governance systems, which increase transparency and help companies become competitive in an open market. "Clearly the aspiration of the Chinese government is to raise overall management capabilities within these businesses," says Mr. Tse.

That was the explicit purpose of the December 2005 sale of a 24.975 percent stake in the country's third-largest insurance company, China Pacific Life Insurance Co. (CPIC Life), also to the Carlyle Group, for $410 million. At the time of the transaction, Carlyle announced the partnership would provide CPIC Life with "strategic, operational and industry expertise to strengthen the company's performance and competitive position." Carlyle outlined additional areas of support, including "corporate governance, risk management, investment management, product sales, marketing and IT systems."

China is treading this path cautiously, however. Russia's "shock" privatization in the 1990s, which led to economic collapse, has proven a powerful lesson to Beijing, says Professor Meyer. "You just don't liquidate state assets overnight. If you do, a few oligarchs end up grabbing everything," he says. Instead, China's government is only gradually loosening its grip, opening the door for outside investors while maintaining a strong state influence. "They want it both ways," says Professor Meyer. "They want companies to act like companies, and not arms of the state, but they also want to retain controlling interest." So far, that demand hasn't dampened foreign interest in the SOEs; the opportunity to crack the Chinese market via an ownership stake of whatever size in large, established domestic companies is still a huge enticement, even if the central government insists on having the upper hand.

Ownership diversification has taken place mainly in the steel, insurance, and construction industries, which are most often controlled out of Beijing, but pushing reform outside the capital city is a greater challenge. Consider China's banks, which would benefit greatly from reform to deal with widespread nonperforming loans and bloated, ineffective management: Most large banks in China are locally entrenched and are focused on parochial interests. "The tug-of-war is between the local governments, which are particularly sensitive to jobs, and the central government, which is trying to put even the largest state-owned enterprises on sound footing," says Professor Meyer. That tension arises in just about all industries undergoing reform — most large SOEs have many local subsidiaries — and can slow down the pace of change.

Buyer Beware

Foreign investors should perform their due diligence with great care, says Mr. Tse. Prior to striking a deal, foreign investors tend to spend time at the acquiring company's main office, where capabilities may be high, leading investors to assume similar skill levels across the entire company. "The competitiveness of some SOEs is quite high, particularly at the headquarters," says Mr. Tse. "But these competencies can drop when you go to the regional or local offices." Such problems are particularly pronounced in Chinese SOEs, says Mr. Tse, where many managers and staff at the local and regional offices lack the right skills and training.

Mr. Meyer cautions against jumping into China for fear of missing an opportunity. China's banking system, as noted above, is particularly perilous, leading many to question why firms like Citigroup — which offered twice the book value for Guangdong Development Bank in a recently quashed consortium deal — are clamoring to get in. Investment in China's national banks, according to Mr. Meyer, opens the entire Chinese market to foreign banks who would otherwise have to be licensed one city at a time. However, the Chinese banks have not completely solved the problem of nonperforming loans (NPLs) and anticipate an increase in NPLs this year. (Although Beijing has given billions in handouts to the banks to cover past NPLs, new high-risk loans are being made at an alarming rate, notes Professor Meyer.)

As with any mergers and acquisitions activity, the number crunching will most likely be the easy part. Once the "hardware" of these deals has been completed, it's the "software" that will pose the biggest challenge, says Mr. Tse. "The best companies in the world have a clear vision and well-defined values that transcend locations and national borders," he says. "How will you get two companies together to agree on a common set of values when values reflect the deepest layers of history?" For example, there are substantial differences in the way Easterners and Westerners approach work. The Western capitalist notions of meritocracy and careers that define the individual will run headlong into the dramatically different views that prevail in China. "For most people working in a SOE," notes Mr. Tse, "it's just a job."

Although Mr. Tse is confident that the government is serious about SOE reform, some observers are reserving judgment until privatization and Western-style governance take a stronger — and more visible — hold. That's still a way off: Beijing's stated goal is to go from about 135,000 wholly state-owned enterprises to a "core" of 1,000. (A lack of transparency on ownership makes those numbers difficult to verify. The vast majority of listings on the Chinese stock exchange are actually for minority shares in subsidiaries of wholly government-controlled companies.)

Not Just for Foreigners

Local investors have also started eyeing SOEs. In early March, a delegation of about 50 firms from Wenzhou, in Zhejiang province on the east coast of China, visited the capital as guests of the Beijing Assets and Equity Exchange Center (BAEEC), which oversees the reform of SOEs, to discuss investment opportunities. The discussions revolved around the possibility of the Wenzhou companies, known for their entrepreneurial skills, either taking over or investing in about 180 SOEs in Beijing. BAEEC president Xiong Yan told the local media that the discussions were intended to send a signal "to the private capital of China that Beijing needs your investment."

In another bold step, the Chinese government is experimenting with inviting outside directors — from within and without the country — to sit on the boards of some of its SOEs. At Baosteel, the number of outside directors on the board exceeds that of internal ones. Booz Allen's Mr. Tse describes the government's experiment as "another way of creating better corporate governance." In traditional state-owned enterprises, he explains, there was no requirement for — and, in fact, no definition of — a board of directors. Concludes Mr. Tse: "The government is now realizing that to truly change an enterprise, you need to go inside of it and fundamentally change its heart and soul."

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