

Macro Keys

Reformation - The China SOE Play

Economics & Macro Strategy

Global

SOE reform in China is key to both the macro picture and micro performance

State-owned enterprise reform is a key component in China's reform toward a more market-based economy. It is also important for equity market performance as SOEs account for more than half the A-share market.

Mixing ownerships instead of privatization

While ideology prevents large scale privatization and the need to protect growth makes mass restructuring unlikely in the near term, the push to develop "mixed ownership" structure can help change management incentive structure, improve core profitability and cash flow, and increase government revenue.

Reforming SOE operating environment

SOEs' operating environment will become more market-based as prices of energy, utility and capital become more market-based, and as competition increases. On this path to increased efficiency, there will be both winners and losers.

Not a wholesale catalyst, need to pick specific winners

We believe investors should focus on sectors and regions that may move faster on the SOE reform front and seek specific opportunities while the macro environment will unlikely be changed soon.

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The central objective of China's ambitious reform plan is to let the market play a decisive role in allocating resources and improve overall efficiency. Reforming the state-owned enterprises (SOEs) is widely considered to be one of the most important pieces of this plan. SOE reform is not only key to sustained macroeconomic growth and financial stability, but also is important for improving corporate profitability, and, given that SOEs account for more than half of the market cap in the A-share market, better performance in the Chinese equity market.

While it is common to equate SOE reform simply to privatization, we think the transformation of SOEs include changes in governance structure, operational independence, incentive systems, budget constraint, and the operating environment. The latter reforms can help improve SOE performance significantly without a massive outright privatization.

In the next couple of years, large scale privatization is unlikely in China, given the continued focus of public ownership as a corner stone of the current political system; the probability of mass SOE restructuring and bankruptcies is also low given the importance of maintaining economic growth and social stability; the Party will likely retain the power to appoint the heads of large SOEs; and SOE budget constraints may not really be "hardened" as the government and banks remain "supporters of the last resort".

Nevertheless, we do expect meaningful progress in the following aspects of SOE reform: developing "mixed ownership", divesting state assets, increasing dividend payment, and transitioning to a more market-based operating environment.

- Developing "mixed ownership" structures among SOEs means partial privatization in essence. This can take different forms including IPO of unlisted state-owned assets, selling certain assets to specific private owners, and increase private ownership of listed companies. For different firms, these measures can pave the way for one or all of the following: adjusting the incentive structure for management (management of "mixed ownership" companies is allowed to link compensation with company performance) to focus more on shareholder returns, improve profitability by getting rid of low-return assets, lower debt leverage, and obtain private capital.
- Divesting state assets could mean getting rid of non-core business operations to improve core profitability, retiring some excess capacities and lower debt leverage through sector consolidation, and at the local level, monetizing state assets to help local government finances. Such measures will also help to reduce bad debt and benefit the banks as well.
- Moving to a more market-based operating environment for SOEs include factor price reform and introducing market competition. The first includes adjusting energy and utility prices, and interest rate liberalization – measures that are already underway and that will reduce implicit subsidies to some SOEs and help re-orient the economy. The second includes opening up certain sectors to private and foreign competition, and levelling the playing field between SOEs and non-SOEs in terms of access to resources and market. There will clearly be both winners and losers in these reforms.
- Increasing SOE dividend payment gradually over the coming years not only should help increase local and central government revenue, but also should help improve SOE governance as their retained "free" cash is reduced and spending is more scrutinized. The latter may lead to lower capex spending and less build-up in excess capacities as well.

How might these types of SOE reforms in China affect overall economic performance and the equity market?

For investors who are looking for large-scale privatization and mass SOE restructuring, the expected gradual and piecemeal SOE reforms will unlikely be perceived as the "game changer", not for the overall economy or the SOE sector as a whole. Nevertheless, these reforms can help improve corporate governance and incentive structure, cash flow and profitability, as well as competitiveness of relevant enterprises. Therefore, at the company and sector level, there could be interesting and significant opportunities for investors. Of course, the reforms could also expose problems in some SOEs and lead to consolidation in some areas.

We think investors should focus on the regions and sectors where SOE reforms may move faster, and on specific aspects and opportunities in these areas. For example, the government is pushing forward with reforms in the petrochemical sector, which may be followed by reforms in the energy (oil and gas, and power) sector. Prices are being adjusted to better reflect market forces while private and foreign companies will have more investment opportunities in the energy and petrochemical sectors. In railway, other transport and public utility sectors, the priority may be to adjust prices and introduce public-private partnership. In competitive industries or those with excess capacities, the focus may be to divest and restructure assets. So far, regions such as Shanghai and Guangdong have already released specific plans for SOE reforms and initiated the first steps while many other provinces will finalize their plans in the coming months.

We expect SOE reform to be a recurring theme playing out in the coming months and years.

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