China Economic Comment
Something Positive from the SOE Reform Plan

Economics

China

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The SOE reform plan is disappointing for the market

The much-awaited SOE reform plan sought to balance the interest of different groups but did not impress the market. The lack of specifics and a clear timetable, as well as wordings on making SOEs bigger and stronger and preventing loss of state assets dampened hope for major SOE divestment and restructuring.

We found some positive messages

In line with the 3rd Plenum reform blueprint, which was well received 2 years ago, SOEs in competitive industries can have the state as minority shareholders; the plans calls for exit of the state from some sectors including through bankruptcies and closure of excess capacities; the government will set up state investment companies to help it move away from SOE management to state capital management; and SOEs are required to improve disclosure and governance, including through paying more dividends to the state shareholders.

Interesting investment opportunities but limited macro impact

As the government starts experimenting with SOE reforms in energy, transport and telco sectors, there could be interesting investment opportunities for investors. However, since major restructuring will be negative for growth and employment and will likely proceed gradually, we see limited impact on macroeconomic front in the coming year.

The much-awaited state-owned enterprise (SOE) reform plan has finally been released. Reaction from China observers and the market is almost uniformly negative. After recent stock market gyration has seriously dampened market sentiment, we thought that a convincing SOE reform plan could be key to boost investor confidence. The just-released reform plan seems to have underwhelmed.

For most investors, the main negative points came from: 1) recognizing SOE as the bedrock of public ownership and socialism, and precluding any major privatization; 2) emphasis on making SOEs stronger and bigger and possibility of SOEs investing in private companies dampening hopes of state divestment, increasing concerns that SOEs could further crowd out private ownership; and 3) strengthening supervision and Party leadership, raising worries of increased politicizing of SOE operation and corporate decisions; and 4) reforms will be very gradual as the government attempts to balance the interests of various groups.

The big gap between public expectation and the government's blueprint for SOE reforms probably stems from what each side saw as the biggest problems currently in the SOE sector. In addition, there may be a lack of appreciation from investors of the constraint the leadership faces in light of the current political and ideological framework, and the need to balance demands from different constituencies or interest groups. For the Chinese leadership, the following problems have affected SOE performance and can be addressed: 1) many SOEs have not established modern enterprise system (shareholding) and are not functioning as market entities, with the role of the government and corporates often blurred; 2) SOEs are not as efficient as could have been due to lack of good management and incentives, unfair social burdens, weak supervision and governance, and may have been in the wrong areas; 3) insider control and corruption has led to loss of state assets, and SOEs have not provided adequate returns to the state shareholders, including not paying or underpaying dividends to the state.

While the new reform guideline provides little detail (which will come out in regional and sector SOE reform plans) and has flaws, we think there are some positive messages that are overlooked. Most notably:

- **In line with the 3rd plenum document** on reform, which was well-received, the new SOE reform guideline insists on market orientation as a guiding principle, reiterates the need for and points to ways to separate state from corporates, and ownership from management, and emphasizes the need to improve SOE efficiency and returns to asset.
- SOEs in the competitive industries will all have a shareholding structure, aim for public listing and whenever possible, public listing for the entire holding group. The state may have an absolute or relatively controlling stake in such SOEs, or **can also be a minority shareholder**.
- The state is prepared to exit some competitive sectors, including by **closing some establishments, allowing for bankruptcies**, and dispose assets through security transactions in the market. The state will accelerate the cleanup of low efficiency asset and retire backward capacity.
- SOEs will be required to **pay a 30% dividend to the state** by 2020, with an increasing share to the budget, while some of their legacy social functions will be restructured or stripped away.
- The government **will establish state investment and operation companies** to supervise and manage state assets (for example SOEs) on behalf of the government, which is seen as a way for the state to move away from enterprise management to state capital management, or often referred to as the Temasek model.

In addition, SOEs will be allowed to have more flexible employment and compensation mechanisms, which may help to improve their incentive systems. SOEs will also be required to provide timely disclosure of their operation, governance, management structure, financial situation, arms-length transactions and management compensation, which can help improve transparency and governance.

The overall plan lacks detail and a clear timeline, which may come out in the forthcoming supplementary plans. One principle is that SOEs will be grouped into commercially oriented ones and those for public welfare. Commercially oriented ones are further grouped into those in the competitive sectors and those in natural monopoly sectors. The plan point to ways that each of the categories can improve market orientation, even in the public welfare oriented SOEs – they can purchase services from non-state businesses, for example (Figure 1).

As the government moves forward with establishing mixed ownership and improve incentive systems in SOEs, we think there may be interesting investment opportunities for equity investors. For example, the government announced that experiment would start in power, oil and gas, railways, telecommunications, aviation and defense industries. From a macroeconomic perspective, we think the impact of the proposed SOE reforms will have limited impact on growth in the coming year. One key reason is that reforms will likely proceed very gradually. In addition, closure of excess capacity and restructuring of SOEs, along with write-off of bad debt, should help rejuvenate the corporate sector in the long term, but in the near term their impact on growth is likely to be somewhat negative.

Figure 1: China's SOE reform plans for different types of companies

SOE classification	Reform objectives	Ownership structure	Performance evaluation
Commercial - Competitive areas	Finish shareholding reform; push for IPO and holding company's group IPO	Introduce other state or private capital; state capital could have an absolute controlling, relative controlling, or minority stake	Operating performance, returns on state asset, market competitiveness
Commercial - Strategic areas	Open competitive areas of natural monopolies for private capital; separate special and competitive business	Encourage private capital's participation; state capital should keep a controlling stake. Wholly state-owned enterprises should invite other state capital	Operating performance, returns on state asset, strategic objectives
Public welfare - Public goods & services	Introduce market mechanism	Either wholly state-owned, or encourage private capital for investment / operation via purchasing services, granting operating rights, etc	Cost cuts, service quality, operation efficiency, public goods provision

Source: Government websites, UBS estimates

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