MARKET COMMENTARY

SEAFARER

State-owned Enterprises and Investing in China

Great Hall of the People, Beijing, China

- State control of companies in China is not as simple as ownership: private companies in China may fiercely pursue their own interests in some areas while acquiescing to government priorities in others.
- Investors only looking at a company's current ownership structure may miss the shifts in Chinese government policy that will shape the future of the business and its industry.
- To reinvigorate growth and improve investor confidence, Chinese policymakers must adopt a more constrained and rules-based approach to state intervention in the economy.

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Nicholas Borst
Vice President and
Director of China Research

In the minds of many investors, Chinese state-owned enterprises (SOEs) conjure up images of moribund and bloated companies that are run for policy objectives and not profits. It's true that state-owned enterprises are less efficient than private firms in China. For example, across the industrial sector, state firms have a return on assets (ROA) less than half that of private firms and the gap between the two appears to be growing.[1] Over the past few years, Chinese authorities have enacted a range of policies to improve the performance of SOEs, including corporatization, industry consolidation and the introduction of outside capital. Unfortunately, these policies have mostly been failures and state-owned enterprises are a significant drag on China's economic growth.

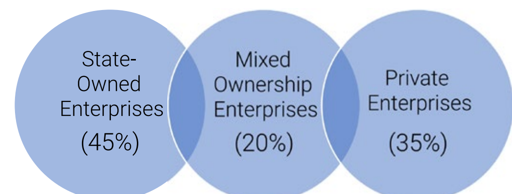
The performance gap between state-owned and private enterprises persists for publicly listed companies. By one estimate, listed private enterprises outperform state-owned enterprises by a factor of 2:1.[2] Given this context, some investors have sought to improve returns by simply cutting the state-owned enterprises out of their investment portfolios. A common approach is to set a threshold for state ownership, such as 20%, and exclude all companies above that level.

While this method of portfolio allocation has some appeal in theory, it falls apart when measured against the complicated realities of state control in China.

The Messy Middle

In China, companies exist across a spectrum of different ownership types, ranging from wholly state-owned to completely private. The universe of listed companies can be sorted into three major categories: state-owned, mixed ownership, and private enterprises. Figure 1 shows the relative proportion of A-share market capitalization amongst these three categories.

Figure 1. A-Share Market Capitalization by Ownership Type



Sources: Wind Information, Seafarer. Data as of August 30, 2019.[3]

Mixed ownership enterprises, or the "messy middle" group, are companies where there is no dominant or controlling owner. Given China's historical transition from communism, many companies started as state-owned enterprises and have subsequently evolved towards a more diversified ownership structure.

Within this mixed ownership category, there may be a variety of different shareholders: individuals, private companies, investment funds, state-owned enterprises, and government entities. Assessing the overall percentage of state ownership often requires researching the nature of each different shareholder. In some cases, determining the ultimate source of ownership is near impossible as beneficial ownership is hidden behind many layers of holding companies.

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An example of a company in the mixed ownership category is Ping An Group, a large insurance and banking conglomerate. Frequently cited as one of China's largest private companies, Ping An was fully state-owned at the time of its founding. Over time, the company became more and more privately-owned and the insurance sector more market-oriented. However, Ping An's single largest shareholder, Shenzhen Investment, is state-owned, and several other state entities own significant portions of the company. Determining whether to amalgamate these holdings into a single control party takes careful analysis. As a result of these complexities, it is difficult to categorize many companies in China as either state-owned or private, and state-ownership thresholds are arbitrary.

There's More to Control Than Ownership

Classifying ownership for companies in the "messy middle" is only part of the challenge. A larger issue exists in the ways that the Chinese government exerts influence over companies outside of formal ownership.

The performance gap separating state-owned and private enterprises is linked to many factors: weak corporate governance, soft budget constraints, insufficient meritocracy, low efficiency levels and a lack of adaptability to changing market conditions. While these problems also exist at many private firms, they are more prevalent amongst state-owned enterprises as a group.

At the heart of the issue is a fundamental question – is a company prioritizing government policy objectives ahead of its own economic interests? These policy objectives can take many forms: promoting the development of a strategic industry, boosting employment, increasing investment ahead of schedule to boost economic growth, controlling information, or producing a critical resource.

One such example is the headlong rush by many Chinese companies to participate in the government's strategic technology campaign.[4] Companies, both state-owned and private, have joined efforts to develop China's own "core technologies" at the behest of the government. While these technologies are important for political and strategic reasons, the economic returns from these efforts are uncertain at best.

Firms that pursue government policy goals ahead of their own economic self-interest can be said to be subject to state control. Performance at these companies suffers as policy goals eclipse other objectives such as profitability and efficiency. For example, if a company's goal is to secure access to a strategic resource, it may seek to do so with little attention paid to cost or productivity.

State control in China, however, is not as simple as ownership. Many private and quasi-private companies take actions to support government policy objectives at the expense of their own economic interests. The extent to which they do so depends on the significance the government places on a policy and the company's dependence on government support and goodwill.

Private companies in China may fiercely pursue their own interests in some areas while acquiescing to state priorities in others. These companies are not completely subject to state control yet are also not entirely free of it.

The Many Tools of Influence

The Chinese government has a range of sticks and carrots that allow it to exert influence over companies where it has no formal ownership. These include, but are not limited to, Communist party cells within the company, direct administrative measures, moral suasion, finance from state-linked financial institutions, tax incentives, and access to critical resources such as land. While some of these tools exist in other countries, such as tax incentives for preferred industries, the range of tools and strength of their application in China is unparalleled.

A case study of these types of actions is the government's approach to the shipbuilding industry. Shipbuilding was targeted as a national strategic industry in the mid-2000s. Through subsidies, preferential financing, administrative guidance, entry restrictions, and pressure for consolidations, the government engineered a massive increase in shipbuilding.[5] China's leaders achieved their goal of becoming a global shipbuilding power, but many of the companies involved were

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left with high amounts of excess capacity that weighed on returns for years to come.

These tools of control are exerted when a company can advance or hinder an important government policy. For example, the government could prioritize the development of a strategic technology and desire the support of China's private tech companies. If the technology is commercially viable, private companies may be perfectly willing to invest in its development. If not, the government may then coerce private companies to participate through incentives (financial support, preferential tax treatment, etc.) or through pressure and implicit threats.

Private companies will assess the cost of supporting the government's objective against the damage to their own economic interests. Given the overwhelming balance of power in favor of the state in China, private companies often prioritize maintaining a good relationship with the government over short-term profits.

The Chinese government itself is not a unitary actor; there are many levels of government and a multitude of bureaucracies, all of which have their own goals and interests. As such, there can be conflicting goals between different governmental bodies. For example, the central government has made efforts to consolidate several industries, including steel, aluminum, coal and others, in order to reduce excess capacity at the national level. Companies in these industries have faced pressure to shut down or merge with their competitors.[6] However, local governments where these companies are located will likely prioritize preserving employment and therefore resist the consolidation. In these instances, a company may find itself torn between divergent demands and must weigh the costs of pleasing one part of the government while angering another.

Charting State Control

Rather than relying solely on ownership as a proxy for state control, a better approach is to look at the interaction between ownership and government policy priorities that conflict with a company's economic interests. Figure 2 presents a stylized overview of state control over listed companies in China.

For simplicity, the relationship between these two factors is sorted into three general categories: low state control, moderate state control, and high state control.

Low State Control: Companies in the lower left quadrant (green) have low levels of state ownership and are not involved in activities involving important government priorities. As a result, these companies are generally subject to lower levels of state control and come closest to the definition of purely private enterprises.

An example of this category would be a privately-owned company in a consumer-focused industry, such as Foshan Haitian Flavouring & Food Co., a large condiment and sauce maker. Previously owned by the Foshan local government, the company was privatized prior to listing and ownership was transferred to its managers. It is hard to detect much in the way in government influence over Foshan Haitian's operations and the company appears to be free to pursue goals that advance its own economic interests.

Moderate State Control: Companies in the upper left and lower right quadrants (yellow) fall into the category of moderate state control.

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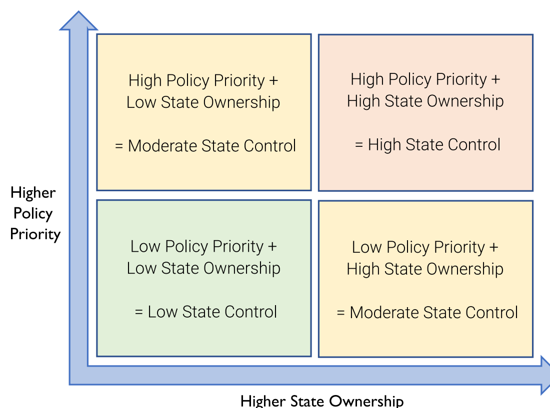
An example of a company in the upper left quadrant is a private firm that operates within a politically sensitive industry, such as internet search. The control of information is a vital policy priority for China's leaders; as such, Baidu, China's leading search provider, must closely adhere to rules, regulations, and even suggestions from the government on how to manage online content. These actions degrade the quality of its search services and reduce its attractiveness to users. While Baidu may be market-oriented in much of its activity, it will periodically take actions that damage its own economic interests in order to appease the government.

Companies categorized into the lower right quadrant include listed SOEs, such as China Resources Beer, a domestic beer producer. A subsidiary of the state-owned conglomerate China Resources Group, China Resources Beer was restructured in 2015 to improve performance and focus on the beer business, and sold its other business lines to its parent company. China Resources Beer operates within a sector that is not considered sensitive or strategic, and there is broad alignment between the company's economic interests and the goal of China Resources Group to increase the value of its holdings.

Figure 1. State Control Over Companies in China



Source: Seafarer.

High State Control: Companies in the upper right quadrant (red) exhibit high levels of state ownership and are linked directly to important government policies. These companies are subject to a significant degree of state control and are less market-oriented in their activities. In the extreme, companies in this category may completely ignore profitability in service of a strategic policy goal.

A business classified into this category would be China Shenhua Energy Company, whose controlling shareholder is Shenhua Group, a state-owned enterprise owned by the central government. Shenhua Group is the country's largest coal producer and in 2017 was instructed to merge with China Guodian Group, a large power generator. The merger was part of a critical policy priority of supply side structural reform, an effort that aims to consolidate across sectors with excess capacity.[7] As a result of the merger, China Shenhua Energy Company injected its power-producing assets into a new joint venture with Guodian and the entire group was reorganized as China Energy Investment Corporation. Mergers across large state-owned enterprises have been primarily policy-driven and have generally not produced subsequent commercial successes.

Bird in a Changing Cage

The last factor that should be brought to bear in the analysis of state control is time. Investors are rightly worried about the impact of state control over businesses. However, looking at this issue at a single point in time may miss meaningful transformations underway at a company.

To adapt an old Chinese saying about economic reform, companies in China are like a bird in a cage.

Prior to listing on public markets, some of China's greatest companies have had high levels of state ownership at establishment and subsequently progressed toward privatization. As discussed previously, Ping An Group was state-owned at the time of its founding and has steadily moved towards a more private and diversified holding structure. The same is true for Foshan Haitian, which can now be considered fully private-owned. Another well-known example of this type is WH Group, a major pork producer that became a global player after its purchase of Smithfield Foods in the United States. For these companies, the major progress towards privatization occurred prior to public listing.

Privatization subsequent to public listing is less common but has occurred intermittently. YiLi Group, a major dairy producer, is a former SOE that privatized after listing, primarily through sale of shares to employees. The company's transition to private ownership may have been permissible because it did not operate within a sector of the economy deemed by the government to be strategic. In contrast, China Unicom, a large mobile network operator, underwent a partial privatization as a strategic ownership stake was sold to a consortium of private tech companies, including Alibaba, Tencent, and Baidu.[8] However, China Unicom still remains subject to high degrees of state control due to the fact that it operates in a strategically important sector, telecommunications.

Indeed, a company that operates reasonably free of state control today may find itself in a different situation in the future. Some industries that started out as relatively freewheeling have become increasingly subject to state control, such as the gaming industry. In 2018, Chinese authorities decided that online gaming was a threat to the health and moral rectitude of the youth of the country.[9] The approval of new games was halted for months and some popular games had to be censored and repackaged to support more government-friendly themes. Gaming companies were rocked by the sudden intrusion of the government into their industry. Investors only looking at a company's ownership structure may miss the shifts in government policy that will shape the future of the business and its industry.

To adapt an old Chinese saying about economic reform, companies in China are like a bird in a cage. Enterprises subject to higher state control have a small cage and are constrained in their ability to pursue their own economic interests. Those less subject to state control have a larger cage and can be more market-oriented, but still face certain limits to their freedom.

Some of the most decisive drivers of performance for companies in China are the moments when the size of that cage begins to change. Identifying these turning points cannot be linked to a simple measure of formal state ownership.

Getting Growth Back on Track?

China's success with state-owned enterprise reform began to flounder in the early to mid-2010s. Rather than allow inefficient SOEs to shut down, Chinese officials instead began to push for mergers and acquisitions (M&A). Policymakers hoped these mergers would create larger and stronger state-owned enterprises; thus far, the reform efforts to improve efficiency and profitability of SOEs appear to have failed.[1]

At the same time, Chinese leaders have become more aggressive in calls for the establishment of Communist party cells within both state-owned and private companies. The city of Hangzhou, a major hub near Shanghai for China's private tech companies, exemplified this trend by dispatching hundreds of "government affairs representatives" to private companies in the area.[10]

These trends contribute to the perception that the Chinese government has become more interventionist and less market-oriented in the past several years. With fewer state-owned enterprises moving towards privatization and many private companies increasingly subject to state control, it's no wonder that the Chinese economy has lost some of its dynamism.

A renewal of market reform is exactly what China requires to reinvigorate growth. Over the past several decades, China grew rapidly in large part by opening up more parts of the economy to competition and forcing uncompetitive state-owned enterprises to shut down. Given space to compete, private firms did flourish, and the remaining state-owned enterprises were forced to become more efficient.

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Chinese policymakers must adopt a more constrained and rules-based approach to state intervention in the economy. When the government runs roughshod over the economic interests of companies, it damages investor confidence and reinforces the notion that politics, not markets, are a key determinant of corporate outcomes. Only by restricting the scope of state control can more space be opened for market competition.

If China does embrace a more market-orientated approach to the economy, it will manifest through further privatization of state-owned enterprises and the expansion of private companies into new areas of the economy. In the meantime, investors must be prepared to grapple with the nuanced complexities of state control in China and its impact on companies, both state-owned and private.

Nicholas Borst

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[2] Gabriel Wilson-Otto, Siward Ludin, Linda Mulyani, Richard Manley, Derek Bingham and Christopher Vilburn, "Risks and Opportunities in China A-shares," Goldman Sachs Equity Research, 10 June 2018. https://research.gs.com/content/research/en/reports/2018/06/10/31880919-3cf0-4351-9b0a-66fb53b6e9e1.pdf

[3] Calculations are based on Wind Information's corporate classification scheme, which includes the following categories: Central state-owned enterprises (中央国有企业), local state-owned enterprises (地方国有企业), private enterprises (民营企业), foreign-invested enterprises (外资企业), collective enterprises (集体企业), and public enterprises (公众企业). For the purposes of this article, the following categorization is used: **State-owned Enterprises:** central state-owned enterprises, local state-owned enterprises, and collective enterprises. **Mixed Ownership Enterprises:** public enterprises. **Private Enterprises:** private enterprises and foreign-invested enterprises.

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State-owned Enterprises and Investing in China

Glossary

Chinese A-Shares: a class of securitized common stock in Chinese companies, traded exclusively on Chinese stock exchanges (i.e., Shanghai and Shenzhen), and denominated in renminbi, China's currency. Historically, A-shares were inaccessible to foreign investors, but more recently China has allowed foreign investors to purchase A-shares through the Qualified Foreign Institutional Investor (QFII) program and the Stock Connect programs.

Mergers and Acquisitions (M&A): the consolidation of companies or assets. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

Return on Assets (ROA): the ratio of annual net income to average total assets of a business during a financial year. Return on assets is one means to measure efficiency of a business in using its assets to generate net income. It is an indicator that simultaneously conveys productivity and profitability.

State-owned Enterprise (SOE): a legal entity that is created by the government in order to participate in commercial activities on the government's behalf. A state-owned enterprise can be either wholly or partially owned by a government.

For More Information

Individual Investors
(855) 732-9220
seafarerfunds@alpsinc.com

Investment Professionals
(415) 578-5809
clientservices@seafarerfunds.com

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As of September 30, 2019, Foshan Haitian Flavouring & Food Co., Ltd. comprised 1.5% of the Seafarer Overseas Growth and Income Fund, China Resources Beer Holdings Co., Ltd. comprised 1.4% of the Fund, and WH Group, Ltd. comprised 1.8% of the Fund. As of September 30, 2019, China Resources Beer Holdings Co., Ltd. comprised 3.1% of the Seafarer Overseas Value Fund, and WH Group comprised 4.3% of the Fund. As of September 30, 2019, the Seafarer Funds did not own shares in the other securities referenced in this commentary. View the Top 10 Holdings of the Seafarer Overseas Growth and Income Fund at www.seafarerfunds.com/funds/ogi/composition. View the Top 10 Holdings of the Seafarer Overseas Value Fund at www.seafarerfunds.com/funds/ovl/composition. Holdings are subject to change.

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