GOVERNMENT SUPERVISION OF M&A DECISIONS BY STATE-OWNED ENTERPRISES IN CHINA[1]

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Abstract

In China, as a socialist market economy, the state performs an important role in the economy not only as a regulator but also as an active market player through the creation and maintenance of state-owned enterprises (SOEs). In the past, means of production were in the hands of the state. But since the introduction of market reforms and the opening up of the economy to private capital and foreign investment, non-state participation in the economy continue to grow and SOEs were made to compete with one another, as well as with private businesses. In the course of these reforms, some SOEs were sold, went bankrupt, or were consolidated to enhance efficiency and competitiveness contributing to the development of the "survival of the fittest" mechanism among

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SOEs (Li, 2003). This is a check against complacency and poor performance and, at the same time, provides incentive to innovative, competitive and performing SOEs. Consolidation of SOEs through mergers and acquisitions (M&As) is seen as one avenue by which the state economy is being reformed. Hence, the state, through such government authorities as the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), ensures supervision and management of SOE activities, including in their M&A activities at home and abroad.

SOE defined

According to Companies Law (Art 65), SOE is "a wholly Stated-owned company with limited liability which is *solely invested in by the State* and for which the State Council or the local people's government authorizes the State-owned assets regulatory institution under the people's government at the corresponding level to perform the duties of an investor" (Companies Law of the People's Republic of China, 2005) (emphasis supplied). In addition, the SOE Law (Art 2) further defines SOE as "an industrial enterprise owned by the whole people . . . shall be a socialist commodity production and operation unit which shall, in accordance with law, *make its own managerial decisions, take full responsibility for its profits and losses and practice independent* *accounting*" (Law on Industrial Enterprises Owned by the Whole People, 1988). (emphasis supplied). This Law passed post adoption of market reforms helped shaped the transformation of SOEs allowing them more space to decide independently provided they observe certain set guidelines and regulations.

SOEs exhibit qualities that set them apart from non-SOEs. For instance, in the case of a Chinese SOE, it serves as an "important enforcer of social and economic transition" (Guo, Clougherty, & Duso, 2013). Hence, unlike other enterprises fixated with maximizing profit, Chinese SOEs are also carriers of "a government's mission and a reflection of social and welfare obligations." At present, there are 117 central SOEs (Central SOEs, n.d.) and despite increasing corporatization and diversification of investment sources, many listed SOEs are still controlled by the state (Lau, Fan, Young, & Wu, 2007).

SOE Reform

SOE reform is the core linkage of China's market-oriented economic reform that began in the late 1970s (Li, 2003). Over the years, the management and operations of SOEs have undergone transformation and SOEs' competitiveness is increasing. Because SOE reform is closely intertwined with the larger state-led economic reforms, an understanding of the economic thrusts and directions set by the government will enable one to better appreciate the behavior Chinese SOEs. This is because SOEs, through their enormous economic omnipresence and clout, constitute one of the fundamental instruments by which the state executes planned economic reforms. Through SOE activities, such as IPO (initial public offering) listing in domestic and overseas equity markets, bankruptcy and sale, and M&A, the state is able to reform the country's economic layout and structure. By closing down loss-making SOEs and merging several SOEs that produce similar or related goods, the quality and the efficiency of the economy is improved. Small and medium-sized SOEs were rationalized through restructuring, coalition, takeover, lease, contractor operation, joint stock operation and selling-off, among others. While retaining control of industries related to national security and the lifeline of the economy, the state is gradually backing out from sectors where market mechanism is proving to be a good means of production and distribution. Local people's governments, as investors in provincial SOEs, are also being encouraged to play a more active role in preserving and increasing the value of state-owned assets within their jurisdictions. The non-public sector is also being expanded and they are also participating in M&A deals involving SOEs. Measures are also being placed to harness foreign capital (Provisions on Mergers and Acquisitions of a Domestic Enterprise by Foreign Investors, 2009) in support of restructuring and reorganizing the economy and this is demonstrated through participation in M&A deals with Chinese SOEs as targets. More areas are being opened for foreign investment, including those that are previously restricted to foreign capital, such as telecommunications, gas, heating, electricity, and pipes. Finally, the state encourages central SOEs to expand and invest abroad and one way of carrying this out is through cross-border M&As.

Today, several of China's SOEs are now ranked among the world's biggest and most profitable in their respective fields. In fact, today, China already has the second largest number of Fortune Global 500 companies in the world (Lin & Milhaupt, 2013). These SOEs are engaged in diverse fields such as energy, power and resources sectors, helping ensure a steady supply of fuel and raw materials to sustain China's growing demand and developmental needs. One of the major activities of these SOEs that has been receiving a lot of attention and scrutiny in recent times is their M&As, especially when it involves high-profile target companies. And as China transitions from being a principal destination of foreign investment to becoming a net capital exporter, M&A activities of the country's SOEs will continue to generate global attention. In fact, China's M&A transactions, both inbound and outbound, has been a major driver in the rebound of the global M&A market in 2010 and 2011 alone (Guo & Rizzi, 2012).

M&A defined

M&A transactions, especially when they involve foreign entities as targets, enable Chinese companies, notably SOEs, to gain access to technology, managerial know-how and experience, establish footprint in new markets, and raise additional capital. Mergers may take several forms as provided for in Art 173 of Companies Law. It can be carried out through amalgamation, with a company amalgamating to another company, the former being dissolved in the process. It can also be executed through a merger of two or more entities establishing a new entity and resulting in the dissolution of the pre-merger entities. Art 174 states that a merger agreement shall be signed by companies about to merge and their respective balance sheet and detailed asset inventory shall be drawn. Creditors shall also be notified within the prescribed period and means so they can claim debt repayment (Art 174). The new entity to emerge from the merger shall assume the claims and debts of all pre-merger companies or the company that was amalgamated to it (Art 175). If changes had been made to the registration items as a result of the merger, the same shall be registered with the proper company registration authority (Art 180). Likewise, if a new company was incorporated post merger, said incorporation shall also be registered accordingly (Art 180).

SOE Law provides certain provisions concerning mergers. According to Art 18 of SOE law, "the merger of enterprises … shall be subject to approval by the government or the competent department of the government in accordance with the provisions of the laws and administrative rules and regulations." Art 20 provides for the protection of the property and liquidation of claims and debts of enterprises being merged. Art 21 provides for approval of changes in the scope of operation of merged enterprises and registration of such changes with administrative authorities for industry and commerce. Compared to their private counterparts, mergers or combinations between SOEs under SASAC supervision are, in practice, generally exempted from anti-trust scrutiny (Zheng, 2009).

SASAC supervision of central SOEs

SASAC "performs investor's responsibilities, supervises and manages the state-owned assets of the enterprises under the supervision of the Central Government (excluding financial enterprises), and enhances the management of the state-owned assets (Main functions and responsibilities of SASAC, n. d.). Founded in 2003 to boost reforms of SOEs , SASAC's internal bureaus handle different aspects of SOE management and supervision including financial supervision and evaluation, property right management, enterprise reform, restructuring, and remuneration, and capital returns management, among others (Internal Bureaux of SASAC, n. d.). Furthermore, it is also responsible for "supervising the preservation and increment of the value of the state-owned assets of the supervised enterprises" (Main Functions of SASAC, n. d.). It is also in charge of appointing SOE top executives, determining their pay and benefits, and approving sales or transfer of SOE stocks or assets. It must be noted that only big central SOEs fall under the mandate of SASAC. Other SOEs, such as those of small and medium scale, are usually under the control and supervision of local governments.

In accordance with law, SASAC decides on such major matters as mergers (Decree of the State Council of the People's Republic of China, 2003). It reviews merger proposals and refers the same to the appropriate level of government for approval (Decree of the State Council, Article 21, 2003). Moreover, when deciding on mergers, SASAC-appointed representatives, shareholders or directors to SOEs "shall voice their opinions and exercise the right to vote according to the instructions of the State-owned assets supervision and administration authority," as well as "report to the said authority in due time about their performance of responsibilities" (Decree of the State Council, Article 22, 2003). Finally, SASAC also coordinates work in relation to mergers and "cooperate with the relevant departments to make arrangements for settling laid-off workers" (Decree of the State Council, Article 22, 2003).

Chinese SOEs directly benefited from government's active support for the "Going Global" strategy. Through this initiative, SOEs are encouraged to expand and invest abroad and one of the primary means by which this is accomplished is through engaging in M&As. Qualified central SOEs are encouraged to go public, introduce strategic domestic and international investors and enter into partnerships with foreign enterprises (Li, 2003; Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2007). Large SOEs are also encouraged to establish factories abroad and to engage in transnational M&A transactions. State assistance for this endeavor is channeled through improved overseas investment consulting, legal guarantee and international coordination systems (Li, 2003).

Moreover, the state also utilizes an array of policy tools to facilitate outward foreign direct investment (FDI) made by SOEs, including "low-interest financing, favorable exchange rates, reduced taxation, industrial guidance, and subsidized insurance for expatriates" (Peng, 2012).

M&As: Chinese SOE style

Chinese SOEs support state goals and objectives in the conduct of their business and their M&A deals may reflect this. Among the goals set by the Chinese government include "obtaining natural resources, acquiring advanced technology and management expertise, pursuing product diversification, expanding financial channels, and promoting brand recognition of Chinese companies in developed nations. As a result, Chinese cross-border merger activity was most active in the following industries: natural resources (e.g., oil, gas, and minerals), services (e.g., banking, transportation, and construction), and some industries involving specialized technologies such as computer, automobile manufacturing, and electricity power generation" (Guo, Clougherty & Duso, 2013; p. 7). These strategic assets were seen as essential in "(1) bolstering economic and social development at home, and (2) compensating for firm-level competitive disadvantages" (Luo & Tung, 2007).

SOEs often weigh two key issues in their M&A decisions: 1) from a profit standpoint - whether the target would enhance the SOE's value and future profitability and; 2) from a social welfare and national economic development standpoint - whether the target would contribute to the attainment of national priorities (Guo, Clougherty & Duso, 2013, pp. 9-10). These two objectives may sometimes conflict with one another and this is where the uniqueness of SOEs comes into being. There will be occasions when public interest and social welfare considerations will trump profit maximization calculus in making acquisitions. Thus, in estimating the value of a target, Chinese SOE do not only look at the financials but also consider the potential value that the target can bring in attaining other non-economic national objectives set by the Chinese state.

Chinese SOEs demonstrate some unique behavior that sets them apart from their non-state peers. For instance, compared to their non-state multinational enterprise counterparts, Chinese SOEs pay higher acquisition premiums when they engage in cross-border M&A deals and such SOEs even pay higher acquisition premiums - "the difference between the actual cost of acquiring a target and an estimate of the targets pre-acquisition value" - when they act as parents and employ a privately-owned company to complete the deal (Guo, Clougherty & Duso, 2013, p. 3). Thus, differences may sometimes arise between the state, which is the majority and controlling shareholder in an SOE, and non-state shareholders in relation to M&As decisions. This can happen for instance when the state decides to acquire a target by offering a bid higher than its estimated economic value arguing that said acquisition may serve perceived non-economic goals. State backing is a major factor that can explain the aggressiveness of Chinese SOEs in undertaking foreign acquisitions. With the state bringing in the weight of accumulated foreign reserves, Chinese SOEs face less constraint in raising capital to finance foreign target acquisitions . In addition, SOEs also enjoy preferential access to loans from state-owned banks, interest subsidies, and special funds to spur foreign trade, aid and development, among others (Guo, Clougherty & Duso, 2013).

Chinese SOEs, like other SOEs from emerging economies, are less efficient in terms of decision-making and corporate management (Guo, Clougherty & Duso, 2013). This inefficiency can be attributed to the perpetual need to balance economic and sociopolitical goals in their actions, including in their M&A involvements. One must also understand that Chinese SOEs are latecomers in the international market and that they suffer from technology handicaps and inadequacy of managerial competency compared to other companies especially from developed countries (Peng, 2012). This and the scarcity of strategic resources in their homeland prompts Chinese SOEs to display more boldness in overseas acquisitions, offering prices usually higher than most competitors. Information asymmetry also plays a role in SOEs' paying higher acquisition premiums (Reuer, Tong, & Wu, 2012). Aside from the target not disclosing full information about itself, variance in institutional environment (notably when acquirer is an SOE and target is a private enterprise) also contributes to difficulty in assessing the real value of the target (Shimizu, Hitt, Vaidyanath,

& Pisano (2004) and this is amplified in the case of cross-border acquisitions.

Another interesting feature of Chinese SOEs in relation to their international activities, including cross-border M&A deals is their close cooperation through inter-group networks. While Chinese SOEs may compete on the home front, SASAC encourages them to collaborate with one another overseas. Linkages between various SOEs involved in complementary industries (e.g. such as those between steel producers and industries that use steel as the primary raw material for their products, such as machine and automobile manufacturers and shipbuilders) facilitate innovation, sharing of information, marketing and pooling of capital for big projects. These collaborations can take the form of equity joint ventures and contractual alliances, which to other jurisdictions can be examined for possible antitrust violations (Lin & Milhaupt, 2013).

Conclusion

As a socialist market economy, the state remain a major actor in shaping and transforming China's economy and one of the means by which this is performed is through its SOEs. Passing an SOE Law and providing a wide range of policy support tools, including almost unlimited financial backing and guarantees, among many other forms of assistance, highlight the significance being attached by the state to SOEs. And these entities, in turn, have been very active at home and recently abroad making M&A deals here and there to secure strategic assets for China and serve other national goals and objectives as defined by the state leadership. However, while the Chinese government issued several guidelines to govern foreign participation in M&A transactions within China, no such clear rules were given to Chinese SOEs as they engage in cross-border M&As. Whether this constitutes an evolving distance being set by the state to give SOEs an autonomous space to make their own decisions or simply the lack of capacity or willingness of the state to oversee the flurry of activities of these SOEs remain a subject of discussion.

It may be difficult to ascertain the internal capacity of these SOEs because of their seemingly intertwined relationship with one another and with the state. But a mechanism to assess the conduct of these SOEs, especially in relation to such actions as M&As, should be made to prevent mismanagement and flawed decisions that can be easily covered up in the competing interests that motivate SOE behavior abroad. There is also a need to come up with the proper balance between profit and social welfare to ensure the viability and profitability of SOEs in the long run. The wide range of support extended to SOEs, while well-intentioned, may stunt the development of efficiency and rationality in SOEs' decision making. Some SOE top officials may make ill-advised decisions thinking that the state will always bail an SOE anyway when it ran into financial woes on account of its ill-studied actions.

Finally, being relatively new to the global market, SOEs must come to terms with different legal jurisdictions and regulatory environments, knowledge and mastery of which can help ensure success. Likewise, familiarizing with the intricacies of the international market environment and developing competencies in such areas as defining best or suitable targets, properly valuating the same and identifying the best method of entering a new market, among others, are important considerations for these SOEs to increase their chance for success. And in all these, the Chinese government can continue to provide appropriate guidance and a big helping hand.

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