China M&A: Reform Plan Promotes Mixed Ownership of State-Owned Enterprises

January 2015

This article is from Skadden's *2015 Insights* and is available at skadden.com/insights.

Contributing Partners

Daniel Dusek
Beijing

Peter X. Huang
Beijing

Contributing Associate

Andre Zhu
Beijing

Chinese state-owned enterprises (SOEs) have played a significant role in the world's second-largest economy, with over 155,000 SOEs valued at approximately $17.4 trillion at the end of 2013 spanning almost every industry sector. Despite the tremendous success some of the SOEs have enjoyed, largely thanks to their monopolistic market positions and entry barriers for private sector competitors, criticism of the overall inefficiency in the management of these assets has increased.

SOE Reform Plans and Implementation

In November 2013, China's new government administration under President Xi Jinping announced, among other economic overhauls, a bold SOE reformation plan, which called for ownership diversification and the withdrawal of SOEs from sectors with healthy, competitive environments. At the same time, the reforms require SOEs to maintain a controlling and influential role in the overall economy.

The language of the reform plan is vague, thus leaving ample room for interpretation and more detailed implementation plans. In addition, Beijing has not yet officially promulgated the list of industry sectors that it considers competitive, giving no indication where the withdrawal of state ownership will likely take place. However, given the large number of SOEs in China and the breadth of sectors in which they operate, the plan has understandably attracted significant interest within the business community. While many observers continue to question the government's will and ability to implement the changes in the face of various incumbent interests, including politically connected elites, several recent developments indicate that the current leadership may actually be serious about implementing this reform.

In April 2014, China's State Council listed 80 projects in state-dominated sectors to private investors, including transportation infrastructure, information infrastructure, clean energy and traditional energy projects. In the same month, the Ministry of Finance announced plans to open China's munitions industry for private investments. Three months later, the State-Owned Assets Supervision and Administration Commission (SASAC) followed suit by announcing pilot implementation programs to reform six central government-level SOEs, two of which — Sinopharm and China National Building Materials Group — will be open to ownership diversification.

At the provincial level, many local governments have responded to the call of the central government. By September 2014, over 20 provinces, spanning most of the major municipalities (including Beijing, Shanghai, Guangdong and Chongqing), had announced concrete implementation programs involving the potential listing or selling off of assets in up to 70 percent of the provincial SOEs by 2017. Chongqing and Guangdong are among those that have laid out the most aggressive targets and timelines. Chongqing pledged to increase the percentage of state-owned assets with mixed ownership from 47.4 percent to two-thirds

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

by 2017 and has designated over 110 projects for reform. These projects involve 25 SOEs and total assets of over $44.2 billion, and more than half of them involve dilution of state ownership. Guangdong committed to reform all of its SOEs and to achieve mixed ownership in at least 70 percent of them by 2017.

Mega-Size Central SOEs Pioneering the Reform Process

In March 2014, CITIC Group, China's largest conglomerate, announced a massive restructuring plan in which it will inject nearly all of its assets, valued at $37.5 billion, into CITIC Limited, a company listed on the Hong Kong Stock Exchange.

In September 2014, SINOPEC successfully sold 29.99 percent of its downstream oil marketing and distribution business, valued at $17.4 billion, to 25 private and social institutions. SINOPEC's new shareholders include a wide variety of institutions, such as private equity funds, industry players, social welfare funds and private enterprises. Based on market intelligence, SINOPEC's share sale process largely targeted Chinese investors, and the private placements were significantly oversubscribed. The other dominant Chinese oil company, PetroChina, has identified specific business segments, such as undeveloped oil and gas reserves, for mixed ownership reform.

Two other leading SOEs, CNOOC and COFCO, also are expected to initiate their reform programs in the near future.

The Role of Foreign Investors in SOE Reform

Due to its potentially broad impact on the Chinese economy, the SOE reform will be implemented gradually, with a trial-and-error period. The central government has yet to publish a list of sectors in which state control will persist, and it is clear that the Foreign Investment Catalogue still will dictate the industries in which foreign investors are either allowed or forbidden to participate. It is still too soon to determine what role foreign investors might play or what appetite Chinese SOEs may have for foreign investment in the ownership diversification process. However, many commentators speculate that, given the large number of SOE players, the successful implementation of the SOE reform would require the participation of foreign capital in one form or another.

In SINOPEC's share sale, many foreign investors, like their domestic counterparts, were invited to submit bids. Although it is clear that priority was given to strategic, domestic and social welfare investors — all of the top subscribers receiving equity allocations in the sale process were state-backed domestic enterprises and funds — some foreign investors' names did appear on the list of the final winning bidders. The largest foreign investor in the transaction, RRJ Capital (a foreign private equity firm run by a former Goldman Sachs partner), was permitted to subscribe for approximately 1 percent of SINOPEC's marketing arm.

The business community is hopeful that SINOPEC is only the first step toward a more market-driven reform process and that, moving forward, local governments may take a more liberal stance toward foreign investments. For example, Chongqing's reform plan expressly invited foreign strategic investors to increase their stakes in projects they have jointly initiated with SOEs.

Conclusion

China's SOE reform and foreign investors' participation in it could take time to unfold. However, given the aggressive plans already outlined by some of the central administrative agencies and provincial governments, and the magnitude of potential state assets to be sold, interested foreign investors should closely follow the reform trend and the opportunities they find attractive.