

**Management of China's State-Owned Enterprises Portfolio:
Lessons from International Experience**

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September 3, 2003

Executive Summary

Analysis of China's portfolio of 174,000 state-owned enterprises (as of end-2001) reveals a clear split. China has some reasonably profitable large SOEs, many of which are centrally administered and/or publicly listed – including some on the Hong Kong and New York stock exchanges. But just over half of China's SOEs are loss-making. The great majority of loss-makers are small/medium SOEs. Locally-administered SOEs pose significant risks of a “localization of benefits” (e.g., wages) and a “nationalization of liabilities” (e.g., additional bank re-capitalization requirements for non-performing loans, un-funded pension liabilities). Thus, China's SOE portfolio poses two issues for the management of State capital. First, what should be done with the cash generated through dividends or proceeds from the sale of relatively good SOEs? Second, what should be done to contain operating losses and the creation of new liabilities from China's many bad SOEs?

A modern capital management system. The preservation and enhancement of State capital will require implementation of a “modern capital management system” through (a) more widespread accounting and auditing reforms; (b) a segmented approach to the management of SOE portfolios; (c) a systematic approach to SOE dividend policy and capital re-investment; (d) central/local agreement on sharing of proceeds and curtailment of liabilities; and (e) enhanced risk management:

(a) Accounting standards now applied to listed companies and foreign-invested enterprises should also be applied to all medium/large SOEs. It would be useful for all large SOEs to experience the *discipline* of a public share offering (including the accounting standards, public disclosure, controls on related party transactions, and independent directors) – even including large SOEs that are *not* suitable for a public share offering. There should be a regular accounting for the central State Assets Supervision and Administration Commission (SASAC) portfolio and the portfolio of each local SASAC. Financial reporting for each SASAC portfolio should similarly reflect international accounting standards, with due consideration for unique Chinese circumstances. Improved management information systems should enable SASAC portfolio managers to focus on key portfolio performance measures. Given the “public” nature of SOEs, including those that are not publicly-listed on stock exchanges, it would be appropriate to increase the transparency of all large SOEs and SASAC portfolios – e.g., by requiring quarterly and annual financial statements and making these available to the public.

(b) It would also be useful for the central SASAC to develop guidelines for segmenting SOE portfolios and managing portfolio segments accordingly. Likely portfolio segments include the following:

- Small/medium SOEs ready for near-term ownership transformation;
- Medium/large SOEs in need of operational and/or financial restructuring;
- Medium/large SOEs whose business is non-viable, which should be liquidated; and
- Reasonably healthy large SOEs suitable for “normal” corporate governance.

Accurate cash flow reporting and projections are the starting point for assessing restructuring options. In turn, higher-quality accounting information is needed to provide accurate cash flow reports and projections.

(c) Large SOEs should each have a formal dividend policy based on a realistic assessment of alternative uses of surplus cash. Cash surpluses on which management cannot expect to earn an adequate risk-adjusted return through reinvestment should be distributed to company shareholders, either through regular dividends or a 1-time dividend. SOE management and boards should avoid ill-considered diversification (“diworseification”).

(d) Proceeds from SOE ownership transformation (e.g., sales) should be used to fund pension liabilities or reduce State debts instead ongoing operating expenses. Central institutions – especially the central SASAC, Ministry of Finance (MOF), large banks, China Banking Regulatory Commission, and National Social Security Fund (NSSF) – should liaise with local counterparts on how to control “localization of benefits-nationalization of liabilities.” Current concerns about avoiding “loss of assets” should be complemented with concerns about avoiding additional accretions of liabilities.

(e) Large SOEs that remain in SASAC portfolios should each implement an appropriate risk management program. “Hard budget constraints,” from adequate systems for creditor right/insolvency and supervision of financial institutions, are needed to support governance at large SOEs and at small/medium enterprises that undergo ownership transformation.

Ownership transformation. The most basic issue is whether China should follow an “open” or “closed” approach to SOE ownership transformation. Over the past decade, except for 1000 or so initial public offerings (IPOs) and foreign-invested joint ventures, ownership transformation has largely proceed through the closed process of management buy-outs (MBOs) or management-employee buy-outs (MEBOs). Apart from offering greater speed and flexibility, closed processes may forestall political debates on the merits of ownership transformation. But worldwide experience conclusively demonstrates the great advantages – both to the State shareholder/seller and individual enterprises – from an open process. Additional empirical work in China to examine this issue would be useful.

It is useful to think about ownership transformation in terms of discrete stages: (a) goals and policies; (b) institutional framework; (c) preparations for sale; (d) conduct of sale; and (e) after-sale:

(a) The goals of ownership transformation should be to maximize sales proceeds and to create the most favorable possible conditions for the future development of former SOEs. Outsiders should have an equal opportunity to compete with insiders to purchase enterprises. It is clear from international experience that outside owners are likely to be more effective in post-sale restructuring and in improving enterprise productivity and profitability. The ownership transformation process should be as open as possible, for

example, through an emphasis on open auctions or open tenders. Open processes are needed to encourage bids from outsiders (who may well be more-qualified buyers), to maximize sales proceeds, and to provide needed transparency.

(b) Transparency and centralized decision-making are essential. Transparency is needed to maintain public support for ownership transformation and to forestall future allegations of corruption. Necessary transparency results from publication of clear and comprehensive rules and procedures to govern enterprise sales; publicity on upcoming sales; dissemination of reliable information on enterprises; a competitive sales process (e.g., public auction, tender, or share offering); equal treatment of domestic and foreign investors; rules on real or potential conflicts of interest; publication of enterprise sales results; and oversight by an appropriate public entity. At least for large or complex sales, use of an outside financial advisor should enhance transparency and sale results. SASACs should have wide discretion to organize and conclude ownership transformations, subject to higher-level approval only for particularly large or important transactions and to post-transaction reviews.

(c) The pre-sale restructuring of SOEs should be minimized. Elaborate calculations of the “going concern” value of medium-sized SOEs are a waste of time and effort. A book value valuation, so long as it includes the value of any real estate (e.g., land use rights), is an adequate reference point for auctions or tender negotiations. An SOE is worth only what a ready and willing buyer will pay for it. Thus, rather than focusing beforehand on calculations of “enterprise value,” SASACs should instead focus on procedures (e.g., bidder access to enterprise information, warranties or indemnifications to manage risks to the buyer, advertising) to maximize competition among potential buyers and minimize their potential uncertainty. This is the most practical approach to maximizing sales proceeds and attracting the most qualified buyers.

(d) The sales method used in each ownership transformation should suit the characteristics and needs of each particular SOE:

- The *sale of small SOEs* and their valuation should focus on the transfer of real estate or access to real estate (e.g., land use rights, leaseholds). Adding other assets (e.g., inventory, fixtures) and liabilities (e.g., debt) to the transaction needlessly complicates the sale of small SOEs. If at all possible, small SOEs should be sold simply for the highest price through a public auction. From our analysis, it is clear that small/medium SOEs do not belong in China’s SOE portfolio. Small/medium SOEs tend to be loss-makers; to diminish rather than enhance State capital; and to cumulatively pose significant liability risks. Full and rapid implementation of the 1999 4th Plenum Decision to “let go” small and medium SOEs and “grasp” the large makes more sense than ever. This, however, will precipitate a huge number of transactions. Hence, an efficient sales program for small/medium SOEs will be especially important.
- *Liquidation* of small SOEs as well as medium-sized SOEs that are insolvent or difficult-to-audit, through asset sale and separate settlement of claims, can be an extremely efficient method for ownership transformation.

- For the great majority of medium/large SOEs, a “*trade sale*” to a dominant shareholder (e.g., strategic investor) should be the preferred method for ownership transformation.
- Except in a few select cases, *initial public offerings (IPOs)* will not be worth the additional time, effort, expense, and risk to public shareholders. The use of IPOs should be limited to large, well-known, and well-run SOEs, whose public offering would contribute to capital market development and where protections for minority shareholders are adequate.
- Closed processes such as *MBOs/MEBOs* should be avoided, except perhaps in the case of small SOEs that are particularly dependent on the scientific/technical skills of enterprise staff. If an MBO/MEBO is used, insiders should be required to pay something for their shares – albeit perhaps at some discount to market value.
- *Mixed sales*, such as a trade sale plus an IPO, are a good way to combine the best features of different methods. For practical reasons (e.g., cost, complexity), however, mixed sales should be limited to medium/large SOEs able to attract strategic (e.g., foreign) investors.

(e) Appropriate post-sale conditions are essential to accomplish the main goals of maximizing sales proceeds and promoting future development of former SOEs:

- *Post-sale restrictions* on the SOE or SOE buyer (e.g., on line of business, enterprise re-sale, worker layoffs) should be avoided, since these are unlikely to achieve any lasting effect – other than reducing sales proceeds.
- Similarly, *post-sale commitments* by the buyer (e.g., on capital investment, technology transfer) can be difficult and expensive for the State seller to monitor and enforce. A higher sales price is preferable to equivalent post-sale commitments by the buyer.
- Government regulations and incentives to deal with SOE *environmental damage* should be clear and predictable.
- SASACs should not insist on retaining residual shares, especially in the case of a trade sale.
- “*Golden shares*” – which may convey special powers to approve or veto such major initiatives as enterprise re-sale to a third party, sale of major assets, liquidation, or reorganization – should be used as infrequently as possible. Any golden share powers should be narrowly-defined, time-limited, and usable only under clearly-specified circumstances.
- Because a lack of wealth or access to financing will constrain many domestic buyers, at least for medium-sized SOEs, SASACs will continue to need to be prepared to agree to purchase financing through *installment payments*. Installment payments, however, should be carefully monitored. In cases where buyers fall behind on installment payments, it may make sense for SASACs to “outsource” resolution of the problem by selling delinquent balances to private investors or hiring commercial collection agents.
- The successful post-sale development of former SOEs will require *complementary policies* in a wide range of areas, including the liberalization of new business entry, macroeconomic stabilization, trade liberalization, creditor rights, banking reform, and business law reform.

- Finally, the clarification and protection of *private property rights* is essential. Past ownership transformations – even those resulting from questionable, non-transparent processes – should be respected. No enterprise owner should ever be divested or driven out of business – including for environmental, health, or safety reasons – by the government without “due process” according to clear and well-established rules, standards, and procedures.

Institutional capacity. The quality of its SOE portfolio will determine institutional requirements for each SASAC. Centrally-administered SOEs are more profitable, less indebted, and less likely to be in distress than locally-administered SOEs.

Hence, the central SASAC as well as local SASACs with higher-quality portfolios (e.g., Beijing, Shanghai) will be able to focus more on maximizing returns on SOE equity and the exercise of normal corporate governance. Core activities at such SASACs should include the monitoring of SOE business planning and performance; participation in annual and extraordinary shareholder meetings; development of SOE boards of directors; and the appointment of SOE directors. Periodically, these SASACs can also be expected to organize share sales in large SOEs. The central SASAC should also be prepared to liaise with local SASACs as well as national institutions to control liabilities growth among locally-administered SOEs. Among large and stable SOEs, their boards will be able to focus on director nominations, board committee structure, and procedures to enhance board oversight of SOE management. Management of such SOEs will be able, in turn, to focus on business plans, investments, and operations to maximize returns on State capital. Based on a portfolio of 196 SOEs, the central SASAC may need 40-100 staff to monitor these SOEs and a cadre of 200-300 individuals to serve as independent non-executive directors.¹ To reinforce the distinction between administrative power and shareholder rights, civil servants should not be appointed as SOE directors. Establishment of a Directors Training Institute and directors accreditation program should facilitate the adoption of international best practices by directors at SASAC portfolio companies.

At the majority of local SASACs, there will be a much greater need for skills in organizing small/medium SOE sales and in restructuring or liquidating distressed or non-viable SOEs. As the nominal owner of these distressed SOEs, local SASACs should also be prepared to negotiate agreements with SOE workers, suppliers, financial institution creditors, and social insurance programs on loss-sharing. Local SASACs will need some training and institutional development in these “special situation” topics as well as in traditional corporate governance tasks. Since the great bulk of small/medium SOE sales, liquidations, and restructuring should occur over the next five years, local SASACs should seek to “outsource” SOE sale, restructuring, and liquidation functions as much as possible – instead of building in-house staff to perform temporary functions.

¹ This assumes that each SASAC staff could monitor 2-5 portfolio companies. It is further assumed that each SOE board will average 7 members, including 3 independent directors, and that each independent director could serve on average on 2-3 SOE boards. Rules to prevent conflicts of interest would be needed.

Market-based working conditions (including compensation) and performance monitoring will be important to attract appropriately-qualified individuals to serve as SASAC staff or SOE directors and to motivate superior performance.

Thus, this background note focuses on China's current SOE portfolio, development of "a modern capital management system," and SOE ownership transformation. A previous background note looked at state asset management reform and steps to enhance corporate governance at large SOEs.² A future background note will consider issues and recommendations for enterprise restructuring.

² William P. Mako and Chunlin Zhang, *Exercising Ownership Rights in State-Owned Enterprise Groups: What China Can Learn from International Experience*, December 2002.

I. Introduction

This background note builds upon the World Bank's previous background note *Exercising Ownership Rights in State-Owned Enterprise Groups: What China Can Learn for International Experience*. That background note broadly considered the issues of state asset management reform. It identified needs to consolidate the State's ownership rights and responsibilities in SOE Ownership Agencies, to focus on the efficient use of state capital, to "let go" small and medium SOEs in order to focus better on governance of large SOEs, to organize new Ownership Agencies according to market principals, to pay more attention to risk management, to create or strengthen SOE boards of directors and rely on these for governing large SOEs, and to transform 2nd tier shareholders (especially enterprise group parent companies) so that they can play an effective role in governance.

Decisions at the 16th CPC Congress in November 2002 and the 10th National People's Congress in March 2003 to enable the central and local governments to exercise the rights of shareholders and to establish a central State-owned Assets Supervision and Administration Commission (SASAC) and local counterparts may profoundly enhance state assets management in China. Success will depend, however, on appropriate organization and operation of the SASACs; adequate controls over the use of State capital; market-based ownership transformation; resolution of distressed SOEs; and effective governance of large SOEs remaining in the State portfolio.

This background paper does not delve into linkages among SOE restructuring, financial sector restructuring, social safety nets, and fiscal sustainability. These linkages are important. For example, the resolution of non-sustainable debt at many SOEs is likely to diminish the capital of state-owned commercial banks. On this issue, there has not been sufficient access to data or demand from the authorities to warrant a closer examination of enterprise-financial sector linkages. Neither does this paper consider regulated infrastructure (e.g., power, telecoms). The focus is on manufacturing and service enterprises in the "tradeables" sector.

The previous background paper provided detailed recommendations on such corporate governance topics as the normal exercise of shareholder rights; selection of directors; organization and working procedures for SOE boards of directors; and typical working relations between shareholders and boards and between boards and management.

Hence, this background paper is organized as follows: Section II assesses China's current SOE portfolio; Section III highlights key issues in the management of State capital; and Section IV compares China's ownership transformation experience with international experience and draws lessons for China. A future background paper will examine SOE restructuring.

II. China's Current Portfolio of State Owned Enterprises (SOEs)

A. Overview of the Portfolio

Between 1997 and end-2001, the number of SOEs decreased by 88,000 – from 262,000 to 174,000 (Table II-1). This decrease has largely been driven by administrative actions: privatizations, “capital structure optimization program” bankruptcies, and mergers or acquisitions (M&A). Local governments have continued to administer about 90% of China's SOEs. During this period, SOE assets have grown significantly – especially among centrally-administered SOEs. The average asset size of centrally-administered SOEs has more than doubled since 1997. Almost all of the overall growth in SOE assets is due to increases in fixed assets and current assets (e.g., receivables, inventory). Some significant part of these increases may be due to SOE M&A transactions.

Table II-1. SOEs and SOE Assets, 1997 and 2001

Amounts in RMB millions

	SOEs			Assets			Average Assets	
	Central	Local	Total	Central	Local	Total	Central	Local
1997	26,000	236,000	262,000	4,862,440	7,635,080	12,497,520	187	32
2001	17,000	157,000	174,000	7,321,100	9,349,860	16,670,960	431	60

Source: *Financial Yearbook of China 2002*.

Of 173,504 SOEs at end-2001, just 9,453 are large while the other 164,051 are medium/small (Table II-2). Small SOEs are especially common in agriculture, food-processing and machinery, commerce (trade, commercial brokerage, catering), and transport. These activities account for 86,633 small SOEs – almost two-thirds the small SOE total. Enterprise workforces average 200 or less in several sectors: e.g., food processing, urban utilities, transport, commerce, and real estate. Of 48.1 million SOE workers, 15.2 million are at centrally-administered SOEs while 33 million are at locally-administered SOEs. As of end-2000, the state was the majority shareholder in 1605 enterprise groups which accounted for perhaps 13,000+ SOEs.¹

The distinction here between centrally and locally-administered SOEs has somewhat been overtaken by events. It has recently been announced that the central SASAC would oversee the governance of 196 SOEs with combined assets shown at RMB 2.5 trillion.² Most of these SOEs are quite large and have a substantial number of subsidiaries or affiliated enterprises. Other SOEs would presumably be governed by local SASACs. Despite this recent change, the distinctions made here in terms of enterprise size,

¹ Enterprise Survey Team, “Development of Enterprise Groups in China,” 2001. Figure of 13,000+ is based on a nationwide average of 8.3 subsidiaries per enterprise group.

² <http://www.people.com.cn/GB/jinji/31/179/20030522/998247.html>

performance and financial strength – as well as the implications for portfolio management – remain valid.

Table II- 2. SOE Size, Workers, and Administration by Sector, 2001

	Enterprises				Workers (000s)			
	<u>Large</u>	<u>Medium</u>	<u>Small</u>	<u>Total</u>	<u>Central</u>	<u>Local</u>	<u>Total</u>	<u>Average Workers</u>
Agriculture	264	1,136	9,066	10,466	1,663	3,163	4,826	0.46
Industry:								
Coal	206	335	1,067	1,608	104	3,219	3,323	2.07
Petroleum	36	23	35	94	1,056	21	1,077	11.46
Metallurgy	362	563	815	1,740	553	2,347	2,900	1.67
Building materials	249	708	1,992	2,949	60	1,005	1,065	0.36
Chemicals	601	1,135	2,345	4,081	190	1,837	2,027	0.50
Forestry	70	102	554	726	36	483	519	0.71
Food	241	859	5,289	6,389	32	783	815	0.13
Tobacco	48	72	57	177	203	22	225	1.27
Textiles	442	821	1,203	2,466	122	1,641	1,763	0.71
Petrochemicals	65	39	62	166	546	100	646	3.89
Medical	188	323	599	1,110	49	440	489	0.44
Machinery	1,211	2,525	6,409	10,145	1,081	3,167	4,248	0.42
Military	284	184	226	694	922	54	976	1.41
Electronics	289	444	921	1,654	146	445	591	0.36
Power	208	658	1,705	2,571	1,132	893	2,025	0.79
Urban utilities	107	285	1,857	2,249	7	484	491	0.22
Other	436	1,055	4,298	5,789	130	1,452	1,582	0.27
	5,043	10,131	29,434	44,608	6,369	18,393	24,762	
Construction	775	1,418	3,355	5,548	1,381	2,163	3,544	0.64
Geo/Water	65	195	1,551	1,811	158	137	295	0.16
Transport	843	2,849	21,759	25,451	3,013	2,652	5,665	0.22
Communications	129	35	117	281	1,304	60	1,364	4.85
Commerce	1,274	7,454	44,110	52,838	751	3,690	4,441	0.08
Real estate	215	1,312	4,570	6,097	25	316	341	0.06
Social services	303	1,553	9,945	11,801	149	1,459	1,608	0.14
Health/welfare	1	14	242	257	3	12	15	0.06
Education etc	42	230	3,866	4,138	41	235	276	0.07
Scientific	97	178	2,485	2,760	148	90	238	0.09
Other	402	1,022	6,024	7,448	217	588	805	0.11
Total	9,453	27,527	136,524	173,504	15,222	32,958	48,180	

Source: *Financial Yearbook of China 2002*.

Data on SOE financial performance and position present significant methodological issues (see Section III.A). However, it appears that SOE profitability has increased since 1998-1999. Net profitability has roughly doubled to 3.7% and the proportion of loss-making SOEs has been reduced from about two-thirds to about half (Table II-3).

Economic growth, debt/equity conversions by AMCs, and other decreases in interest expense have presumably contributed to improved profitability. But SOE privatizations, mergers, and bankruptcies may have been more important. Notably, the 84,000 decrease in loss-making SOEs since 1997 almost equals the 88,000 decrease in total SOEs. However, 51% of SOEs were still loss-making in 2001. For 2001, China's SOEs showed RMB 281 billion in overall profit, with profitable SOEs contributing RMB 480 billion and loss-making SOEs destroying RMB 199 billion in value. In addition, a high and increasing level of current assets-to-sales indicates an SOE liquidity problem. Current assets have increased to 313-325 days of sales since 1997. Unless SOEs are maintaining large cash balances, which seems unlikely, this suggests that increasing amounts of working capital are tied up in possibly un-collectible receivables and un-saleable inventory.

Table II-3. SOE Profitability and Liquidity, 1997-2001

Amounts in RMB millions

	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
Sales revenue	6,813,200	6,468,510	6,913,660	7,508,190	7,635,550
SOE profits	n.a.	328,020	329,070	467,980	480,470
SOE losses	n.a.	(306,650)	(214,490)	(184,600)	(199,360)
Net profit	79,120	21,370	114,580	283,380	281,120
Net profitability	1.2%	0.3%	1.7%	3.7%	3.7%
Percentage loss-making	65.9%	68.7%	53.5%	50.7%	51.2%
Profitable SOEs	89,000	74,000	101,000	94,000	85,000
Loss-making SOEs	173,000	164,000	116,000	97,000	89,000
Total SOEs	262,000	238,000	217,000	191,000	174,000
Current assets	5,369,850	5,575,110	5,935,170	6,682,560	6,678,560
Current asset-days 1/	288	315	313	325	319

Source: *Financial Yearbook of China 2002*.

1/ Represented as days of sales.

SOE profitability varies by locality. In 2001, over 60% of SOEs in Beijing and Shanghai were profitable (Table II- 4). By contrast, over 60% of SOEs were unprofitable in the northeast provinces of Liaoning and Jilin; the central provinces of Anhui, Henan, and Hubei; the southwestern provinces of Guangxi, Hainan, Chongqing, Sichuan, and Yunnan; and the northwestern province of Gansu.

Table II-4. Profitability of Locally-Administered SOEs by Region, 2001

(Amounts in RMB 100 million)

	<u>Number of</u> <u>Enterprises</u>	<u>Sales</u> <u>Revenue</u>	<u>Profit</u>	<u>Profit-</u> <u>ability</u>	<u>% Loss-</u> <u>Making</u>
Beijing	4,211	1,915.8	52.9	2.8%	36.1%
Tianjin	4,987	1,123.3	10.1	0.9%	49.9%
Hebei	7,583	1,732.4	-2.6	-0.2%	42.6%
Shanxi	5,872	1,023.6	-3.7	-0.4%	42.1%
Inner Mongolia	2,131	559.1	-0.8	-0.1%	44.9%
Liaoning	5,462	1,789.7	-39.1	-2.2%	63.0%
Jilin	3,325	627.6	-14.4	-2.3%	62.0%
Heilongjiang	6,323	705.4	-33.0	-4.7%	53.2%
Shanghai	13,398	4,861.8	198.3	4.1%	33.4%
Jiangsu	8,108	3,234.4	2.3	0.1%	53.8%
Zhejiang	5,393	2,606.1	101.6	3.9%	40.4%
Anhui	4,798	1,238.5	16.8	1.4%	64.2%
Fujian	5,594	1,202.9	25.3	2.1%	49.3%
Jiangxi	4,548	745.2	-5.4	-0.7%	56.3%
Shandong	7,807	3,347.4	51.3	1.5%	47.1%
Henan	8,289	1,488.5	6.1	0.4%	64.3%
Hubei	5,724	1,087.0	-20.0	-1.8%	61.0%
Hunan	6,575	1,016.6	-2.7	-0.3%	58.2%
Guangdong	11,523	4,922.6	220.7	4.5%	55.3%
Guangxi	6,617	739.6	-2.6	-0.4%	62.9%
Hainan	1,408	130.9	-0.9	-0.7%	71.5%
Chongqing	2,141	565.1	-7.3	-1.3%	66.0%
Sichuan	4,781	1,087.5	8.1	0.7%	60.9%
Guizhou	3,261	328.8	-0.3	-0.1%	55.0%
Yunnan	4,494	761.3	-3.1	-0.4%	60.9%
Tibet	531	30.0	-1.7	-5.7%	53.9%
Shaanxi	4,757	753.9	-5.9	-0.8%	53.0%
Gansu	3,443	436.7	-10.0	-2.3%	62.4%
Qinghai	691	86.7	0.6	0.7%	59.2%
Ningxia	698	179.7	0.3	0.2%	59.0%
Xinjiang	<u>2,063</u>	<u>328.4</u>	<u>-5.8</u>	<u>-1.8%</u>	<u>51.9%</u>
Totals	156,536	40,656.5	535.1	1.3%	51.2%

Source: *Financial Yearbook of China 2002*.

The most-distressed SOE sectors are building materials, chemicals, forestry, food processing, textiles, machinery, urban utilities, construction, transportation/storage, and commerce. In 2001, these sectors showed province-wide losses in more than half of China's provinces (Table II-5). Returns on equity were worse than *negative* 20 percent in about 1/3 of China's provinces in the case of textiles and commerce. In many cases, it appears that SOEs have been de-capitalized as a result of ongoing losses and –

presumably sustained by outside bank, vendor, or government financing – are just hemorrhaging cash.³ Even in the case of less distressed sectors, sector-wide averages may mask deep distress among individual SOEs.

Table II-5. Provincial Negative Returns on Equity (ROE) for Locally-Administered SOEs, by Sector, 2001

<u>Sector</u>	<u>% of # Provinces, by Negative ROE</u>					
	<u>Negative Provinces</u>	<u>0-neg.10%</u>	<u>Neg. 10-20%</u>	<u>>neg. 20%</u>	<u>Worst ROE</u>	
Agriculture	77%	20	4	1	-448%	Jiangxi
Industry:						
Coal	39%	11	1		-11%	Qinghai
Petroleum	19%	4		2	-62%	Jilin
Metallurgy	23%	5	2		-17%	Shaanxi
Building material	58%	12	3	3	-75%	Chongqing
Chemicals	58%	13	2	3	-638%	Hainan
Forestry	68%	12	4	5	-183%	I. Mongolia
Food	61%	8	6	5	-1428%	Shaanxi
Tobacco	23%	3	1	3	-34%	Jilin
Textiles	68%	10	2	9	-88%	Hubei
Petrochemicals	26%	5		3	-37%	Hunan
Medical	6%	1		1	-112%	Guizhou
Defense	45%	7	3	4	-81%	Shanxi
Machinery	71%	14	3	5	-36%	Heilongjiang
Electronics	39%	12			-8%	Guangxi
Power	16%	3	1	1	-708%	Ningxia
Urban utilities	61%	17	2		-16%	Hainan
Other	45%	10	2	2	-35%	Shanghai
Construction	52%	16			-9%	Liaoning
Transport/storage	52%	9	2	5	-111%	Heilongjiang
Commerce	68%	4	5	11	-2089%	Xinjiang
Real estate	45%	10		4	-345%	Hainan

Source: *Financial Yearbook of China 2002*.

Sector data show that overall liabilities/equity for China's SOEs was about 1.6:1 at end-2001 (i.e., a liabilities/assets ratio of 0.61) Aggregate data for 1997-2001 show that China's locally-administered SOEs have remained more highly indebted, with liabilities/equity of about 220% (0.69 liabilities/assets) versus 125% (0.56 liabilities/assets) for centrally-administered SOEs. A number of sectors, however, are highly leveraged with liabilities/equity in excess of 2:1.⁴ These include building

³ Enterprise de-capitalization presumably explains some very high negative ROEs for specific sector-provincial pairs: e.g., -638% for chemicals in Hainan; -708% for power in Ningxia; and -2089% for commerce in Xinjiang.

⁴ Liabilities/equity of 2:1 was considered a risk threshold in South Korea, where the financial supervisor required over-indebted *chaebols* to reduce liabilities/equity to 2:1 within a 2-year period. It would be

materials, chemicals, wood processing, food processing, textiles, machinery, defense, and other industrial production, as well as construction, commerce, real estate, and the small health/welfare sector (Table II-6). These activities accounted for 50% of the end-2001 liabilities of China's SOEs. High leverage probably means an inability to meet obligations to lenders, vendors, etc.

Table II-6. SOE Liabilities and Leverage, End-2001

(Amounts in RMB millions)

	<u>Liabilities</u>		<u>Equity</u>	<u>Liabilities/Equity</u>
Agriculture	205,865	2.1%	100,920	204%
Industry:				
Coal	286,549	2.9%	165,503	173%
Petroleum	135,723	1.4%	477,569	28%
Metallurgy	560,608	5.8%	385,939	145%
Building materials	163,813	1.7%	70,153	234%
Chemicals	409,805	4.2%	172,572	237%
Forestry	32,170	0.3%	10,961	293%
Food	137,142	1.4%	31,832	431%
Tobacco	119,145	1.2%	113,129	105%
Textiles	209,616	2.2%	55,921	375%
Petrochemicals	161,071	1.7%	147,476	109%
Medical	101,831	1.0%	55,816	182%
Machinery	790,001	8.1%	320,824	246%
Military	206,068	2.1%	65,478	315%
Electronics	201,339	2.1%	101,582	198%
Power	1,114,667	11.5%	722,838	154%
Urban utilities	79,100	0.8%	103,902	76%
Other	<u>255,368</u>	<u>2.6%</u>	<u>119,967</u>	<u>213%</u>
	<u>4,964,016</u>	<u>51.0%</u>	<u>3,121,462</u>	<u>159%</u>
Construction	589,550	6.1%	140,353	420%
Geo/Water	29,306	0.3%	55,145	53%
Transport	1,451,051	14.9%	800,257	181%
Post/Telco	560,588	5.8%	682,980	82%
Commerce	1,374,823	14.1%	334,809	411%
Real estate	647,375	6.7%	151,470	427%
Social services	208,279	2.1%	158,683	131%
Health/welfare	4,971	0.1%	2,155	231%
Education etc	43,334	0.4%	58,773	74%
Scientific	33,554	0.3%	21,741	154%
Other 1/	<u>(387,062)</u>	<u>-4.0%</u>	<u>514,876</u>	n.m
Total	9,725,650	100.0%	6,143,624	158%

Source: *Finance Yearbook of China 2002*. Includes both central and local SOEs

1/ Adjustment to make sector details add to totals in *Finance Yearbook of China, 2002*.

preferable to use other indicators of financial resiliency, such as interest coverage ratios. But the data available on China's SOEs do not support such calculations.

As noted earlier, a rising ratio of current assets/sales revenue suggests increasing liquidity problems for SOEs. Indeed, there has been an attempt to identify “unhealthy” assets (e.g., outmoded fixed assets, un-collectible receivables, un-saleable inventory). Table II-7 shows estimates of unhealthy assets relative to total assets and equity for locally-administered SOEs as well as the effect write-downs of assets and equity for unhealthy assets would have on liabilities/equity ratios:

- Unhealthy assets are minimal (i.e., less than 10% of total assets) in a few locales: Beijing, Shanghai, Zhejiang, and Fujian.
- However, unhealthy assets represent more than 20% of assets in ten provinces: Liaoning, Jilin, Heilongjiang, Jiangxi, Hubei, Hunan, Guangdong, Chongqing, Shaanxi, and Xingjiang.
- With no adjustment for unhealthy assets, only seven provinces show liabilities/equity worse than 200% (i.e., liabilities/assets worse than 0.67): Jilin, Heilongjiang, Jiangxi, Henan, Hubei, Shaanxi, and Xinjiang.
- With adjustment, all but four provinces (Beijing, Shanghai, Zhejiang, Tibet) show liabilities/equity worse than 300% (i.e., liabilities/assets worse than 0.75).
- Moreover, with adjustment, the SOE sector in five provinces (Jilin, Heilongjiang, Jiangxi, Hubei, and Shaanxi) would be insolvent (i.e., negative equity). In these provinces, liabilities exceed adjusted assets by RMB 90 billion.
- Adjusting for unhealthy assets reduces equity in locally-administered SOEs by more than half, from RMB 2.9 trillion to RMB 1.4 trillion. Overall liabilities/equity go from 252% to 632% (i.e., to 0.86 liabilities/assets).

As serious as these figures are, it is not clear whether there has been adequate accounting for SOE liabilities. For example, if SOE accruals for interest expense and worker pensions have been inadequate, full accounting for these liabilities would further raise liabilities/equity ratios.

Table II-7. Effects of “Unhealthy” Assets on Solvency of Locally-Administered SOEs, 2001
(Amounts in RMB millions)

Locality	Unadjusted				Unhealthy Assets/ Equity	Adjusted for Unhealthy Assets		
	Assets	Liabilities	Equity	Liabilities/ Equity		Assets	Equity	Liabilities/ Equity
Beijing	556,120	372,800	183,320	203%	22.60%	514,690	141,890	263%
Tianjin	320,340	210,060	110,280	190%	44.50%	271,265	61,205	343%
Hebei	419,150	308,840	110,310	280%	58.40%	354,729	45,889	673%
Shanxi	284,050	203,240	80,810	252%	49.50%	244,049	40,809	498%
In. Mongolia	162,860	118,080	44,780	264%	55.00%	138,231	20,151	586%
Liaoning	515,890	386,160	129,730	298%	91.00%	397,836	11,676	3307%
Jilin	317,890	290,650	27,240	1067%	259.30%	247,257	-43,393	-670%
Heilongjiang	317,890	278,010	39,880	697%	187.80%	242,995	-35,015	-794%
Shanghai	1,178,510	794,880	383,630	207%	28.40%	1,069,559	274,679	289%
Jiangsu	617,520	429,270	188,250	228%	38.30%	545,420	116,150	370%
Zhejiang	453,330	279,860	173,470	161%	13.40%	430,085	150,225	186%
Anhui	295,090	219,250	75,840	289%	69.30%	242,533	23,283	942%
Fujian	262,610	170,920	91,690	186%	27.50%	237,395	66,475	257%
Jiangxi	196,350	150,740	45,610	330%	108.30%	146,954	-3,786	-3982%
Shandong	674,820	484,400	190,420	254%	43.10%	592,749	108,349	447%
Henan	377,900	289,250	88,650	326%	76.10%	310,437	21,187	1365%
Hubei	304,530	235,930	68,600	344%	107.50%	230,785	-5,145	-4586%
Hunan	259,530	186,610	72,920	256%	78.80%	202,069	15,459	1207%
Guangdong	1,108,630	775,220	333,410	233%	42.80%	965,931	190,711	406%
Guangxi	216,030	138,490	77,540	179%	55.60%	172,918	34,428	402%
Hainan	72,070	52,920	19,150	276%	54.10%	61,710	8,790	602%
Chongqing	168,620	124,890	43,730	286%	92.30%	128,257	3,367	3709%
Sichuan	297,470	195,780	101,690	193%	49.40%	247,235	51,455	380%
Guizhou	120,680	87,470	33,210	263%	57.80%	101,485	14,015	624%
Yunnan	203,040	145,340	57,700	252%	45.40%	176,844	31,504	461%
Tibet	13,850	6,370	7,480	85%	33.30%	11,359	4,989	128%
Shaanxi	212,470	167,260	45,210	370%	104.90%	165,045	-2,215	-7550%
Gansu	136,120	93,820	42,300	222%	58.50%	111,375	17,555	534%
Qinghai	28,920	21,070	7,850	268%	54.50%	24,642	3,572	590%
Ningxia	43,150	30,500	12,650	241%	52.40%	36,521	6,021	507%
Xinjiang	<u>81,820</u>	<u>63,640</u>	<u>18,180</u>	<u>350%</u>	94.70%	<u>64,604</u>	<u>964</u>	<u>6605%</u>
Totals	10,217,250	7,311,720	2,905,530	252%		8,686,963	1,375,243	632%

Source: *Finance Yearbook of China 2002*.

The foregoing problems notwithstanding, a small top tier of Chinese enterprises has shown strong financial performance as well as reasonable disclosure and governance.

For example, Chinese companies with shares listed in Hong Kong generally showed a strong 2001 performance in terms of returns on equity (Table II-8). These companies show adjustments to their Chinese-statutory accounting for international and U.S. accounting standards; retain Big 4 auditors who follow Hong Kong auditing standards; limit and disclose related party transactions in conformity with Hong Kong regulations; retain international investment banks to value major acquisitions; and – while still majority state-owned – include one or more director-representatives from strategic/financial investors on their boards.⁵ Given the apparent success of such publicly-listed corporations in terms of financial performance and corporate governance, it may be useful for all large SOEs to experience the *discipline* of a public offering (especially the international accounting standards, extensive public disclosure, controls on related party transactions, and independent directors) – even including large SOEs that are *not* actually suitable for a public share listing.

**Table II-8. Returns on Equity (ROE) for
Selected H Shares, 2001**

Angang New Steel	4.6%
Qingling Motors	6.6%
Tsingtao Brewery	3.3%
China Aluminum	11.3%
Jiangxi Copper	7.4%
Yanzhou Coal Mines	12.2%
PetroChina	15.9%
Sinopec	9.7%
Beijing Yanhua	-5.2%
Shanghai Petrochemical	0.9%
Yizheng Chemical	1.9%
Zhenhai Refining	5.6%
Beijing Datang	10.4%
Huaeng Power	12.2%
Shandong Power	19.2%
Great Wall Technology	3.7%
Travelsky Technology	18.9%
Nanjing Panda	30.0%
Beijing Capital Airport	5.8%
China Eastern Airlines	1.8%
China Shipping Development	6.1%
China Southern Airlines	9.0%
Guangshen Railway	7.5%

Source: JPMorgan.

⁵ For example, see China Petroleum and Chemical Corporation (Sinopec), *Annual Report and Accounts 2001*, pp. 55-57; China Mobile and Rothschild, “Major Transaction and Connected Transactions,” 27 May 2002; and Huaneng Power International and JPMorgan, “Connected Transaction,” 22 November 2002. In 2001, Sinopec’s board included directors from Exxon Mobil and Cinda AMC.

B. Implications for State Asset Management

The split nature of China's SOE portfolio – some reasonably profitable large SOEs and many distressed SOEs of all sizes, but mostly small or medium – has important implications for implementation of the state asset management reforms mandated by the 16th CPC Congress and the 10th National People's Congress:

1. Additional reforms are needed to facilitate not just more efficient use of State capital, but its actual preservation.
2. Up to 150,000 small and medium SOEs should be “let go” within the next five years – a huge task that will require efficient approaches to ownership transformation and restructuring or liquidation.
3. Resolution of large numbers of distressed SOEs will require market-based allocations of losses plus more capacity to do operational and financial restructuring.
4. While central SASAC may be able to focus on SOE governance, local SASACs will need to focus more on SOE ownership transformation and restructuring.

1. State capital

China's SOEs pose two issues for the management of State capital. First, what should be done with the cash generated through dividends or sales proceeds from relatively good SOEs? The second is less pleasant – i.e., how to contain and share operating losses, losses on sale, and restructuring losses from China's many bad SOEs?

Historically, China's SOE sector has overwhelmingly emphasized jobs preservation over the efficient use of capital. This is clear from such indicators as the maintenance of 89,000 loss-makers in the SOE portfolio, the progressive de-capitalization of at least ten sectors, and the insolvency of five provincial SOE portfolios. From the earlier description of locally-administered SOEs, there appears to be a significant “localization of benefits” (e.g., preservation of jobs, “leaking out” personal gains) leading to a “nationalization of liabilities.” These national liabilities are almost certain to include *additional* requirements for the eventual re-capitalization of state banks, to cover losses from non-performing loans (NPLs) to SOEs, and for the National Social Security Fund (NSSF) to cover local social insurance shortfalls for workers.

Thus, the most urgent task is preservation of State capital. The prompt sale of small/medium SOEs is likely to be the most obvious way of mitigating the risk of “localization of benefits – nationalization of liabilities.” Also urgent is the restructuring or liquidation of distressed or non-viable SOEs. The process of selling or restructuring SOEs, however, will precipitate the recognition of losses from excess claims and require some resolution.

Dividends and sales proceeds from good SOEs will provide some financial resources to cover claims. In at least some provinces, however, local financial resources will probably not suffice to cover claims.⁶ Thus, it will be important for the central and local

⁶ This applies both to privatization and liquidation. Most often, claims on an enterprise are paid out of sale proceeds or enterprise assets. Excess pools of financial resources – e.g., to satisfy financial institution

authorities to work out arrangements for sharing of gains and losses as well as appropriate financial management systems. The central SASAC should be in a leading position to work with the local SASACs and liaise with other national authorities (e.g., the state banks, NSSF, and Ministry of Finance) to facilitate SOE ownership transformation and restructuring and to make arrangements for the sharing of gains and losses.

To make sound decisions on dividend policy, enterprise valuations, and enterprise restructuring, SASAC staff will need better accounting data. As suggested earlier, there is no cause for confidence that current data on the financial performance and position of China's SOE portfolio is materially correct. Finally, to address the "localization of benefits – nationalization of liabilities" issue, the authorities (especially central SASAC) will need to give serious attention to risk management.

2. Ownership transformation

Small and medium enterprises (SMEs) do not belong in China's SOE portfolio. The data suggest that small/medium SOEs diminish rather than enhance State capital. Small/medium SOEs tend to be perpetual loss-makers. In addition, because their finances are especially non-transparent, small/medium SOEs pose high risks of additional liabilities. While individually insignificant, the large numbers of SMEs represent a collectively large claim on the attention of officials and a distraction from the potentially more rewarding enhancement of large SOE governance.

While full and rapid implementation of the 1999 4th Plenum Decision to "let go" small SOEs and "grasp" large SOEs makes more sense than ever, this would precipitate a huge number of transactions. Leaving aside small/medium SOEs that may be affiliated with enterprise groups, as many as 150,000 small/medium SOEs should be "let go." Profitability and solvency data (Tables II-4, 5, 6, & 7) suggest that perhaps half of these could be sold as viable businesses while asset sales/liquidations would be more appropriate for the other half.

Implementation of a program for selling small/medium SOEs will need to guard against the "loss of state assets" through asset-stripping and unreasonably low sale prices for SOEs. But professional and independent valuations for up to 150,000 small/medium SOEs seem impractical. Alternative means (e.g., better information, seller warranties, advertising) for getting the highest possible sales price are discussed in Section IV.B).

3. SOE restructuring

SOE restructuring will be more carefully examined in a subsequent background paper. But it is clear that SOE restructuring raises two big issues.

creditors and social insurance obligations – are unlikely to be available at the municipal or provincial level in most cases.

First, how will losses from SOE restructuring be allocated? The claims of employees, suppliers, financial institution creditors, and social insurance programs, utilities, and tax authorities will likely exceed the value of distressed SOE assets. Hence, losses will need to be shared among claimants in a way that balances immediate social needs with needs (e.g., creditor rights) for development of a market economy.

Second, who will provide the institutional capacity? As seen in the recent East Asia crisis, the operational and financial restructuring of distressed enterprises is time-consuming and labor-intensive. China is fortunate in that significant enterprise restructuring experience already exists in some enterprise groups and the four asset management companies (AMCs).⁷

4. Institutional capacity

Portfolio quality will determine institutional requirements. Centrally-administered large SOEs are more profitable, less leveraged, and less likely to be in distress than locally-administered SOEs.

Hence, central SASAC as well as local SASACs with stronger portfolios (e.g., Beijing, Shanghai) will be able to focus more on maximizing returns on SOE equity and the exercise of normal corporate governance. Core activities at such SASACs will include the monitoring of SOE business planning and performance; participation in annual and extraordinary shareholder meetings; development of SOE boards; and appointment of board members. Periodically, these SASACs can also be expected to organize share sales in large SOEs. As suggested above, the central SASAC should also be prepared to liaise with local Ownership Agencies and other national institutions. As for large and stable SOEs, their boards will be able to focus on director nominations, committee structure, and procedures to enhance board oversight of SOE managements. Management of these SOEs will be able, in turn, to focus on business plans, investments, and operations to maximize returns on State capital. Based on a portfolio of 196 SOEs, the central SASAC may need 40-100 or so staff to monitor these SOEs and a cadre of 200-300 or so individuals to serve as independent non-executive directors.⁸ Establishment of a Directors Training Institute and directors accreditation program should facilitate the adoption of international best practices by directors at SASAC portfolio companies.

At most local SASACs, however, there will be much greater need for skills in organizing small/medium SOE sales and in restructuring or liquidating distressed or non-viable SOEs. As nominal owner of these distressed SOEs, local SASACs should also be

⁷ For example, SAIC in autos, Jawa in consumer products, Sinopec in refining/petrochemicals, and Haier in white goods already have experience in restructuring/liquidating SOEs. Much of this experience, however, has involuntarily resulted from administratively-mandated M&A takeovers of highly distressed SOEs. There is wide agreement that M&A activity needs become based more on market principals.

⁸ This assumes that each SASAC staff monitors 2-5 portfolio companies. It is further assumed that each SOE board will average 7 members, including 3 independent directors; and that each independent director serves on an average of 2-3 SOE boards. Rules to prevent conflicts of interest would be needed. While appointed by SASAC, independent directors (as well as executive directors) should not be civil servants so as to reinforce the necessary distinction between administrative power and shareholder rights.

prepared to negotiate agreements with SOE workers, vendors, financial institution creditors, and pension programs on cost-sharing and assumption of remaining liabilities. Some training and institutional development is obviously important for local SASACs in these topics as well as in traditional corporate governance tasks. Since the great bulk of small/medium SOE sales, liquidations, and restructuring should occur over the next five years, the local SASACs should look to “outsource” these functions as much as possible.

Market-based employment conditions (including compensation) and performance monitoring will be important to attract appropriately-qualified individuals to serve as SASAC staff or SOE directors and to motivate superior performance.

III. A Modern Capital Management System

Over the past two decades, China has steadily moved to implement a modern enterprise system. The goal has been to improve the competitiveness of China's enterprises.

Somewhat analogously, the preservation and enhancement of State capital will require implementation of a modern capital management system through (a) more widespread accounting and auditing reforms; (b) a segmented approach to the management of SOE portfolios; (c) a systematic approach to SOE dividend policy and capital re-investment; (d) agreement between central and local governments on sharing of SOE gains and losses; and (e) enhanced risk management, including hard budget constraints on SOEs. For each of these topics, this section compares what is known about current practice in China with international best practices.

A. Accounting and Auditing

Accounting and auditing reforms should cover individual SOEs and enterprise groups as well as the SOE portfolios of the central SASAC and each local SASAC.

1. SOE and enterprise group accounting

Accurate financial statements are essential for investors to make realistic decisions on enterprise performance, valuation, sale, restructuring, or re-investment. Accounting standards now applied to listed companies and foreign-invested enterprises should also be applied to all medium/large SOEs. Listed SOEs (i.e., about 1000 enterprises) as well as foreign-invested enterprises (FIEs) are obliged to follow the new Accounting Systems for Business Enterprises (ASBE). ASBE standards, where they have been developed, are reasonably close to International Accounting Standards (IAS). Problems arise from the fact, however, that the great majority of SOEs continue to follow older accounting regulations which are sometimes much less conservative than IAS and sometimes much more strict (see Table III-1).

**Table III-1. New vs. Old Accounting Standards
for Chinese Enterprises: Selected Accounting Items**

<u>Accounting Item</u>	<u>Joint Stock Companies and Foreign-Invested Enterprises</u>	<u>Other State-Owned Enterprises</u>
Short-term investments	<ul style="list-style-type: none"> • Short- vs. long-term based on management's intention • Shown at lower of cost or market value • Impairment provision in case of a permanent impairment of value 	<ul style="list-style-type: none"> • No guidance on classification • Shown at cost

Accounts receivable	<ul style="list-style-type: none"> Provision for bad debts should be based on management's experience and judgment. May be applied to specific balances, as a % of overall balance, or by applying different % to different receivables age brackets 	<ul style="list-style-type: none"> Provision for bad debt may not exceed 0.3-0.5% of accounts receivable balance
Inventories	<ul style="list-style-type: none"> Carried at lower of cost or net realizable value Impairment treated as general and administrative expense 	<ul style="list-style-type: none"> Carried at cost. Provision for diminution in value generally not allowed without approval from authorities Impairment treated as a selling cost
Long-term investments	<ul style="list-style-type: none"> Carried at cost unless there is a permanent diminution in value. Then an impairment provision should be made for the difference Accounted for using equity method if investment >20% of investee voting rights <u>or</u> able to control investee 	<ul style="list-style-type: none"> Carried at cost If investment >20% of investee equity <u>and</u> significant influence can be demonstrated, investor has option to use equity method
Consolidated financial statements	<ul style="list-style-type: none"> Required if company holds >50% of another entity's equity or with smaller ownership has the ability to exercise control 	<ul style="list-style-type: none"> Focuses on percentage of ownership; not control
Fixed assets - depreciation	<ul style="list-style-type: none"> Useful life of asset based on management's judgement Depreciation method is based on management experience and judgement Depreciation method may be straight-line or accelerated 	<ul style="list-style-type: none"> Useful life determined by government; may not be realistic Depreciation method set by government Straight-line depreciation generally prescribed
Fixed assets - impairment	<ul style="list-style-type: none"> Impairment provision required in case fixed asset is damaged; not in use and not expected to be used in foreseeable future; technically obsolete; used to produce sub-standard products; or no longer beneficial to company 	<ul style="list-style-type: none"> Not addressed
Finance leases	<ul style="list-style-type: none"> Liability and asset shown 	<ul style="list-style-type: none"> Only lease expense is shown
Construction in progress	<ul style="list-style-type: none"> Carried at cost unless impaired, in which case provision similar to other fixed assets impairment 	<ul style="list-style-type: none"> Carried at cost; impairment not addressed
Land use rights	<ul style="list-style-type: none"> If not idle (" intangible asset") or recent construction ("construction in progress"), shown as separate LUR line item 	<ul style="list-style-type: none"> Shown in separate LUR line item
Foreseeable liabilities	<ul style="list-style-type: none"> A provision should be made for foreseeable liabilities, such as restructuring costs, redundancy costs, or warranty costs 	<ul style="list-style-type: none"> Not addressed; some of these costs could be accrued in "other liabilities"

Source: accounting industry. See also Nicholas R. Lardy, *China's Unfinished Economic Revolution*, (Brookings Institution, 1998), pp. 33-47.

Thus, old-style non-ASBE accounts can vary from modern ASBE accounts in the following important ways:

- Short-term and long-term investments valued at cost may be over-valued if there has been a decline in market value. This could also lead to an overstatement of income and equity.
- Accounts receivable are almost certainly overvalued, since bad debts are always more than the 0.5% permitted by regulation. This would cause income and equity to be overstated.
- Inventories (along with income and equity) may be overstated if there is a lot of inventory that is obsolete or sub-standard and cannot be sold.
- There may be an under-consolidation of accounts, which could result in overstatements of revenues, income, and equity as a result of related party transactions.
- Fixed assets may be over-stated, due to too-slow depreciation, or overstated due to a failure to show effects of impairment from damage, obsolescence, or non-use.
- Fixed assets and liabilities may be understated from failure to account for financial leases.
- Fixed assets will be understated if there has been inadequate accounting for the market value of land use rights.
- Failure to account for foreseeable liabilities – e.g., restructuring costs, redundancy costs – would cause an overstatement of income and equity.

Some simple examples in just one of these areas – accounts receivable – illustrates the potential impact from adoption of new international standards, i.e., ASBE. The switch to realistic bad debt accounting from a statutory maximum of 0.5% can require a major 1-time provision that would reduce income and equity. Companies listed on the Hong Kong Stock Exchange, for example, have already made this adjustment. By comparing actual reported receivables with what would have been reported net of a 0.5% bad debt allowance, it appears that just this switch to ASBE accounting for receivables could cause a 1-time reduction in net income (and retained earnings) of at least 20-25%.¹ Other old-style treatment of items, especially land use rights, may tend to understate SOE accounts. But in the great majority of differences, old-style accounting is likely to overstate SOE income, equity, and assets and to understate SOE liabilities.

In the case of affiliated SOEs – for example, in many of China’s state-majority enterprise groups – it appears that there is no proper consolidation of accounts except in the case of listed SOEs. In most cases, the accounts of multiple affiliated SOEs (including the effects of cross-affiliate sales) may be simply combined rather than consolidated to eliminate the effects of inter-affiliate transactions. This would tend to overstate revenues, income, and equity within enterprise groups.

¹ The 20-25% figure is based on an analysis of SOEs listed on the Hong Kong and New York Stock Exchanges. These are among China’s best companies. Thus, the impact of a switch to ASBE receivables accounting for other less-good companies would almost certainly be more severe.

2. Portfolio accounting

Similarly, periodic financial statements for each SASAC portfolio will be needed to assess each SASAC's management of its assigned portion of State capital. Austria's OIAG state shareholding fund is probably the most complete example of accounting for an SOE portfolio.² OIAG's annual financial statements provide a public accounting for portfolio assets, liabilities, and income (Box III-1).

Box III-1. Accounting Practices at Austria's OIAG SOE Fund

As of end-2001, OIAG's holdings included 7 publicly-traded companies (or subsidiaries) and 7 non-public companies, including 100% of Austria Post. These holdings, some investment securities, and cash represent most of OIAG's assets.

Market values are available for the publicly-traded companies. OIAG typically values all holdings at cost (book value), however. Holdings are depreciated at annual rates of 20-33%. Any long-term impairment in the value of a holding is accounted for by an extraordinary depreciation charge.

OIAG's mandate includes sale of State shares in SOEs. At the time of sale, a holding is "written up" if actual market value exceeds its cost basis. This write-up appears as operating income on OIAG's income statement. OIAG shares 80% of the profits from any sale of a holding with Austria's Ministry of Finance. Such profit-sharing is treated as an operating expense.

OIAG's liabilities include provisions for severance payments, pensions, all identifiable risks, and un-quantifiable liabilities. OIAG segments some of its earnings in several reserve funds. The sale of a holding may precipitate a provisions cancellation and/or reserves release, which would count as operating income.

OIAG's net profit for 2001 was ATS 341 million. OIAG's supervisory board concurred with management's recommendation to carry this amount forward as retained profit.

For 2001, OIAG's accounts were audited by the local affiliate of Ernst & Young (E&Y), an international accounting firm. E&Y certified that OIAG's "accounts and annual financial statements comply with the relevant legal provisions" and that OIAG's financial statements "observe the principles of adequate and orderly accounting and to the maximum extent possible present a true and fair view of the company's assets, financial situation and profitability."

² New Zealand has recently improved government accounting for SOEs. Before July 2002, the government's financial statements showed a consolidated net surplus for all SOEs in the government's operating balance (income statement) and a consolidated net investment value for all SOEs in the government's balance sheet. Since July 2002, the government's financial statements and forecasts show consolidated revenues, expenses, surplus, assets, liabilities, and equity for all SOEs. R. Hamilton, "New Zealand Accounting Policies on SOEs," correspondence, July 29, 2003. Singapore's Temasek SOE fund does not make public its financial statements.

Source: OIAG, *Annual Report 2001*.

Periodic financial statements for each SASAC portfolio should similarly reflect international accounting standards. China's ASBE standards already provide a starting point for SASAC portfolio accounting. According to ASBE, short-term equity investments should be carried at the "lower of cost or market." For long-term equity investments where a SASAC owns 20 percent or more of the enterprise's equity – or can otherwise exert control or influence – the "equity method" of accounting should apply. Under the equity method, which would likely apply to most of the medium/large SOEs in SASAC portfolios, SOE profits would increase the SASAC's investment balance and investment income; SOE losses would decrease the SASAC's investment balance and investment income; and SOE dividends would increase the SASAC's cash balance while reducing its investment balance. For either long- or short-term equity investments, any permanent reduction in value should be reflected in a provision to the SASAC's investment balance and a realized loss of investment income.

In overseeing the implementation of improvements in financial reporting for SASAC portfolios, it would be useful for the central SASAC to seek advice from a qualified international accounting firm. It may be necessary to address additional accounting issues not yet covered by ASBE. In addition, while implementing international accounting standards, careful consideration should be given to the unique circumstances of China's SOE portfolios (e.g., large numbers of non-tradable shares, significant minority shareholdings, insolvent provincial portfolios). Lastly, it would be a good idea to resolve valuation issues (e.g., for "unhealthy" SOE assets) before establishing initial balance sheets for central and local SASAC portfolios. Any international accounting firm that has had a major presence in China over the past 1-2 decades could usefully advise central SASAC on these matters. Any such international firm would also be able to advise and assist SASACs in improving their management information systems and identifying appropriate portfolio performance goals (e.g., returns on equity). These additional steps are also necessary to support the effective management of State capital.

Given the "public" nature of SOEs, even those that are not publicly-listed on stock exchanges, it would be appropriate to increase the transparency of all large SOEs and SASAC portfolios. This could involve, for example, a requirement for annual and quarterly financial reporting and a commitment to make these reports available to the public.

3. Auditing

The material accuracy of financial statements should be independently audited according to international audit standards. All countries have some financial mis-reporting. China is no exception. An official investigation of almost 200 Chinese companies found that 54 percent mis-reported profits in 2001.³ Independent audits conducted according to international audit standards are an important deterrent to

³ *China Daily*, January 10, 2003.

financial mis-reporting. The effective implementation of *adequate* audit standards also depends on SOE boards of directors and external auditors. The board of directors should be responsible for the integrity of financial statements prepared by management and for overseeing external auditors. External auditors should be responsible for validating the SOE's financial statements and the adequacy of other information disclosures.

B. Portfolio Segmentation

Other countries with large SOE portfolios that include a significant number of distressed SOEs have segmented the portfolio and applied an appropriate method(s) to each segment of the portfolio. As indicated in Section II, about half of China's SOEs are unprofitable and likely in moderate-to-severe distress. This is not dissimilar to past situations facing the SOE portfolios of other transition or OECD countries:

- In Italy, the IRI state holding company's portfolio was highly distressed by 1992-9: annual losses were \$8.3 billion and consolidated debt was \$58 billion. Per Italy's agreement with the European Union to repay these debts and reduce its debt/equity ratio to about 1:1. During 1992-2000, IRI conducted 160 major asset sales – e.g., two banks, auto maker SEAT, Rome airport, toll roads, 31 percent of Alitalia airline, and most of the Finmeccanica aerospace company – for Lira 65 trillion (about \$53 billion). IRI itself was liquidated in 2000. Its remaining shareholdings – public television RAI, 30 percent of Finmeccanica, and 54 percent of Alitalia – were transferred to the Italian Treasury. While a failure at financial management and enterprise restructuring, IRI succeeded in liquidating itself and – like OIAG in Austria – stimulating development of Italy's capital market. Former IRI companies account for 45 percent of Italy's current stock market capitalization.⁴
- In East Germany, the *Treuhandanstalt* transformed over 12,000 SOEs. Of these, 53 percent were sold, 30 percent were liquidated, and 17 percent were transformed through restitution or other means.⁵
- In Poland, between 1990 and end-1996, about 40 percent of 8,441 medium/large SOEs entered ownership transformation through a liquidation or insolvency process (see Table IV-3).

Thus, depending upon the size and condition of any particular SOE in a SASAC portfolio, any of the following may be most appropriate: sale as a “going concern,” asset sale or liquidation, operational and/or financial restructuring, or normal corporate governance.

It would be useful for the central SASAC to develop some guidelines for segmenting local SASAC portfolios (as well as its own portfolio) and managing portfolio segments accordingly. Segmentation should reflect SOE size plus financial performance and condition. It makes sense to sell small/medium SOEs, either as “going concerns” or

⁴ Olivier Butzbach, background note on IRI, May 23, 2002, mimeo.

⁵ *Final Report of the Treuhandanstalt*, December 31, 1994, Bundesanstalt für vereinigungsbedingte (Federal Agency for Unification Tasks), pp. 1-5.

through asset sales/liquidations.⁶ Many medium-sized SOEs, however, may need “operational restructuring and/or “financial restructuring” before they could be sold.⁷ Similarly, some large SOEs destined to remain in the State portfolio may need operational and/or financial restructuring. Ultimately, some medium/large SOEs may be non-viable because of basic business flaws and would better be liquidated. Company cash flows are a good preliminary indicator of the health or distress of individual enterprises. The need for accurate cash flow reporting reinforces the need for more widespread implementation of accounting reforms. Such an analysis of 2000+ enterprises in Central Europe in 1992-94 showed a high-but-declining incidence of distress (Table III-2). At one extreme, profitable companies (Column A) are candidates for “normal” corporate governance. At the other extreme, companies that cannot pay all wages or suppliers (Column D) are candidates for extensive operational restructuring or liquidation. Between these extremes, a company may have enough cash flow to service its debt, but still show an accounting loss when depreciation is included as an expense (Column B). Such companies are prime candidates for operational restructuring to increase earnings. Other more-distressed companies may be able to pay wages and vendors, but unable to meet all debt service obligations (Column C). Such companies would need more extensive operational restructuring. If it appears that operational restructuring cannot suffice, then some financial restructuring to reduce corporate debt to a sustainable level would become appropriate.

**Table III-2. Application of Segmentation
To Enterprises of Selected Countries, 1992-1994**
(percentages of enterprises, weighted by employment)

<i>Country</i>	<i>Year</i>	<i>Profitable</i>	<i>Unprofitable</i>			<i>Total</i>
			<i>Positive Cash Flow</i>	<i>Cannot service all debt</i>	<i>Cannot pay all wages or suppliers</i>	
		<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	
Bulgaria	1992	20	2	35	43	100
	1994	33	9	30	28	100
Czech Rep.	1992	60	13	7	20	100
	1994	81	11	4	4	100
Hungary	1992	59	6	15	20	100
	1994	67	12	8	13	100
Slovakia	1992	61	17	7	15	100
	1993	71	15	3	11	100
UK	1992	93	5	1	1	100

Source: World Bank, *Restructuring Large Industrial Firms in Central and Eastern Europe*, 1996, p. 7.

⁶ See Section IV for further discussion of the merits of selling small SOEs – even healthy small SOEs – through asset sales.

⁷ “Operational restructuring” includes discontinuation of less-profitable or loss-making businesses, layoffs of excess labor, and other cost reductions to increase a company’s earnings and debt service capacity, plus sales of non-core businesses and assets (e.g., real estate) to retire debt. “Financial restructuring” may include term extensions, rate reductions, or conversion of debt into equity or into convertible bonds.

C. Dividend Policy and Capital Reinvestment

Dividend payments, by those companies that pay dividends, are usually regular (e.g., quarterly) and somewhat predictable. Occasionally, a company may make a special one-off dividend payment, especially if it has a large cash balance that cannot be invested at an adequate expected return. A key measure is the “dividend payout ratio” – the ratio of dividends to net income. The appropriate dividend payout ratio for a particular company will depend on its growth prospects, capital structure, and investment opportunities.

China’s best SOEs, such as those listed on the Hong Kong and New York Stock Exchanges, seem to follow international best practices in terms of dividend policy and the payment of dividends (see Box III-3).

Box III-3. Dividend Policy at a Major SOE

Dividend policy for one SOE listed on the Hong Kong and New York stock exchanges is subject to approval by the company’s Board of Directors. Up to 35 percent of net income can be paid out as dividends. Actual dividend payments in 2001 and 2002 were at this maximum dividend payout ratio.

Each year’s dividend payment is proposed by company management. It must then be approved by the Board and finally approved at the annual general meeting (AGM) of shareholders.

In making its dividend decisions, the Board’s Strategic Committee and company management jointly review cash projections, debt/equity structure, and capital expenditure (CAPEX) needs. Any proposed CAPEX should clear a specified “hurdle rate” (14 percent return on capital invested) in order to be approved.

It appears, however, that the great majority of China’s medium/large SOEs take a much less formal approach to dividend policy and in fact do not pay dividends. This may reflect a widespread attitude that SOE managements have a “management right” to decide themselves on the use of excess cash. This informality may lead to the accumulation of large cash balances and the opportunistic and un-disciplined investment of these cash balances. For example, some major Chinese SOEs have acquired or sought significant stakes in the initial public offerings (IPOs) of completely non-related businesses. Chinese SOEs also make private equity investments in unrelated non-core businesses.⁸

Internationally, dividend payout ratios tend to reflect the growth prospects of each company. For example, companies with relatively slow and dependable growth can

⁸ For example, World Bank staff are familiar with one capital goods company that has maintained long-term equity investments in such unrelated businesses as securities, mineral water, traditional Chinese medicine, and advertising. This is in spite of the fact that this company does not pay dividends, allegedly needs additional funds for CAPEX, and is in increasing arrears on debt service to creditors.

typically support a dividend payout ratio of about 50%. (Table III-2) American securities analysts regard a payout ratio of 50 percent or less as reasonably secure and “defensible.” Companies with strong cash flows (e.g., Pfizer) may maintain high payout ratios despite high R&D costs and high returns on equity (ROE).

Table III-2. Dividend Payout Ratios: Slow-Growth Companies, 2003

<u>Sector</u>	<u>Company</u>	<u>Country</u>	<u>Market</u> <u>capitalization</u>	<u>Return</u> <u>on equity</u>	<u>Earnings</u> <u>per share</u>	<u>Dividends</u> <u>per share</u>	<u>Payout</u> <u>ratio</u>
			<u>(\$ millions)</u>	<u>(ROE)</u>	<u>(EPS)</u>		
Appliances	Electrolux	Sweden	6,880	11%	2.59	1.24	48%
Pharmaceuticals	Pfizer	US	271,600	45%	1.51	0.6	40%
	Novo Nordisk	Denmark	12,200	n.a.	1.9	0.38	20%
Diversified	3M	US	50,900	32%	5.12	2.64	52%
	GE	US	292,500	24%	1.48	0.76	51%
	Siemens	Germany	46,400	8%	2.33	0.85	36%
	United Technology	US	33,900	26%	4.5	1.08	24%
Food Processing	ADM	US	8,600	7%	0.72	0.24	33%
	ConAgra	US	12,600	18%	1.58	0.99	63%
Oil integrated	Statoil	Norway	18,300	32%	1.1	0.37	34%
	Repsol YPF	Spain	19,500	n.a.	2.33	0.42	18%
	Petrobras	Brazil	22,200	25%	2.19	0.17	8%
	Eni	Italy	60,400	18%	6.81	3.31	49%
	Royal Dutch	Netherlands	96,900	20%	3.59	1.42	40%
	Total	France	154,200	18%	2.97	1.47	49%
	BP	UK	154,200	16%	2.97	1.47	49%
	Exxon Mobil	US	240,800	21%	2.29	1	44%
Consumer Goods	Colgate	US	31,200	n.m.	2.26	0.96	42%
	Gillette	US	33,600	54%	1.19	0.65	55%

Source: Yahoo Finance, company profiles, July 7, 2003.

Regulated utilities may comfortably support an even higher dividend payout ratio. Among foreign companies, payout ratios may reach 70 percent for highly-regulated utilities with relatively regular demand and relatively predictable cash flows and CAPEX requirements, such as local phone service and power distribution (Table III-3). Lightly regulated infrastructure companies with more variable demand and significant capital costs, such as railroads, may only be able to support lower payout ratios.

Table III-3. Dividend Payout Ratios: Utilities/Infrastructure Companies, 2003

<u>Sector</u>	<u>Company</u>	<u>Country</u>	<u>Market</u> <u>capitalization</u> <u>(\$ millions)</u>	<u>Return</u> <u>on equity</u> <u>(ROE)</u>	<u>Earnings</u> <u>per share</u> <u>(EPS)</u>	<u>Dividends</u> <u>per share</u>	<u>Payout</u> <u>ratio</u>
Communications	AT&T	US	15,700	3%	1.36	0.75	55%
	Verizon	US	110,100	20%	2.29	1.54	67%
	British Telecom	UK	28,600	n.m.	7.87	1.08	14%
Electric Utilities	Consolidated Edison	US	9,220	11%	3.06	2.24	73%
	Scottish Power	UK	11,300	14%	2.32	1.83	79%
Railroads	CP	Canada	3,680	14%	2.15	0.35	16%
	CSX	US	6,680	7%	2.06	0.4	19%

Source: Yahoo Finance, company profiles, July 7, 2003.

For companies in cyclical industries, dividends may reach or exceed 100 percent of earnings during cyclical downturns. Recent experience provides plenty such examples (Table III-4). Indeed, companies may continue to pay dividends despite a loss-making year in order to satisfy shareholder demands for regular and predictable interest payments.⁹ Shareholders disgruntled by a disruption in regular dividend payments may massively sell company shares, thereby punishing the company's share price.¹⁰ Cyclical companies often accumulate cash reserves during cyclical upturns and draw down cash reserves during cyclical downturns. Many of the cyclical companies shown below are notable for their relatively low returns on equity (e.g., ROE <15%).

⁹ Some of the dividend amounts in this table are "indicative" – i.e., amounts now expected for the current quarter based on communications from management.

¹⁰ For example, when Ford omitted its regular dividend in 1982, shareholder sales drove Ford's share price down to a 25-year low.

Table III-4. Dividend Payout Ratios: Cyclical Companies, 2003

<u>Sector</u>	<u>Company</u>	<u>Country</u>	<u>Market</u> capitalization (\$ millions)	<u>Return</u> on equity (ROE)	<u>Earnings</u> per share (EPS)	<u>Dividends</u> per share	<u>Payout</u> ratio
Aerospace	Boeing	US	28,000	14%	1.55	0.68	44%
Autos/components	Daimler	Germany	37,200	7%	3.14	1.61	51%
	Ford	US	20,400	16%	0.63	0.4	63%
Chemicals	GM	US	20,100	20%	5.43	2	37%
	Johnson Controls	US	7,780	18%	6.74	1.44	21%
	NL Industries	US	849	11%	0.82	0.8	98%
	Monsanto	US	5,860	2%	0.43	0.52	121%
	BASF	Germany	25,500	8%	2.74	1.25	46%
	Dow	US	28,600	-4%	-0.4	1.34	-335%
	Dupont	US	42,000	18%	1.92	1.4	73%
Steel	Posco	South Korea	8,980	10%	2.81	0.59	21%
	Nucor	US	3,910	7%	2.04	0.8	39%
	Siderurgica	Brazil	1,760	51%	6	2.45	41%
Mining	US Steel	US	1,630	6%	1.09	0.2	18%
	Alcoa	US	21,700	5%	0.6	0.6	100%
	Alcan	Canada	11,000	3%	0.83	0.6	72%
	BHP Billiton	Australia	22,400	11%	0.44	0.29	66%
	Pechiney	France	3,770	-1%	-0.22	0.48	-218%
	Rio Tinto	UK	27,400	6%	1.32	2.4	182%
Capital Goods	Milacron	US	162	-6%	-0.57	0.04	-7%
	Hitachi	Japan	17,900	1%	0.69	0.43	62%

Source: Yahoo Finance, company profiles, July 7, 2003.

It is especially important to update policies on dividends and capital investment for high-growth or high-technology companies. Such companies usually – but not always – do not pay a dividend. If a company can earn returns on equity of 25 percent or more and needs additional capital for expansion or modernization (e.g., Nokia, Adobe, Oracle), it makes sense for the company to re-invest all of its earnings in the business rather than pay dividends. (Table III-5). Of course, some re-investments (e.g., biotechnology companies) have uncertain prospects and may take a long time to pay off. In addition – as the post-1999 performance of Motorola, Ericsson, Nortel, and Corning illustrate – a company may be both high-technology and cyclical. In such cases, it is especially important for the company’s management and board to consider the likely effect of additional CAPEX on long-term competitiveness. Finally, an extended period of high growth may more or less exhaust a company’s future prospects for high growth. It may make sense for such companies to begin paying dividends. Microsoft is a good example of this. Given the slowdown in Microsoft’s growth to 9 percent over the past five years,

and the accumulation of \$49 billion in cash reserves (as of mid-2003), Microsoft recently decided to begin paying a modest dividend. As these examples illustrate, it is especially important periodically to re-examine assumptions about growth and future returns on capital invested (ROCI) for companies classified as high-growth or high-technology.

Table III-5. Dividend Payout Ratios: High-Growth/Technology Companies, 2003

<u>Sector</u>	<u>Company</u>	<u>Country</u>	<u>Market</u> <u>capitalization</u> <u>(\$ millions)</u>	<u>Return</u> <u>on equity</u> <u>(ROE)</u>	<u>Earnings</u> <u>per share</u> <u>(EPS)</u>	<u>Dividends</u> <u>per share</u>	<u>Payout</u> <u>ratio</u>
Aerospace	Aviall	US	231	10%	1.02	-	0%
	Flir	US	1,070	29%	1.18	-	0%
Pharmaceuticals	Biogen	US	6,150	12%	1.25	-	0%
	Amgen	US	88,900	-10%	-1.02	-	0%
Technology	Cisco	US	127,900	12%	0.46	-	0%
	Nokia	Finland	84,700	27%	0.83	0.26	31%
	Motorola	US	23,200	-16%	-0.82	0.16	-20%
	Ericsson	Sweden	18,200	-27%	-1.86	-	0%
	Nortel	Canada	11,400	-90%	-0.7	-	0%
	Corning	US	9,540	-41%	-1.81	-	0%
	Peoplesoft	US	5,700	9%	0.56	-	0%
Software	Satyam	India	1,530	20%	0.5	0.11	22%
	Adobe	US	8,030	27%	0.86	0.05	6%
	SAP	Germany	37,800	22%	0.56	0.14	25%
	Oracle	US	65,800	40%	0.43	-	0%
	Microsoft	US	294,400	18%	0.88	0.08	9%

Source: Yahoo Finance, company profiles, July 7, 2003.

While regular dividends are more the norm, a 1-time dividend or return of capital may be appropriate if the enterprise cannot expect to earn an adequate return from the re-investment of its cash reserves. During preparations for an IPO of shares in Norway's Statoil, for example, a financial review concluded that the company had too much equity – more than it could efficiently use. As a result, Statoil's IPO coincided with a 1-time return of Statoil capital to the State treasury.¹¹ New Zealand companies may also pay a special one-time dividend (Box III-4).

¹¹ Ongoing dividend payments are governed by Statoil's dividend policy, which includes an item that dividends will not be paid if the company's equity falls below a certain percentage of total assets. Olivier Butzbach, background note on Statoil, June 23, 2002, mimeo.

Box III-4. Dividend Policy for New Zealand's SOEs

Successive governments have taken a close interest in the potential dividends that may be derived from SOEs. Although it is natural to expect that SOEs may be perceived as “cash cows,” a constructive but conservative approach has been taken with regard to dividend policies. Although the basis for an SOE’s balance sheet aims toward a 60/40 debt/equity ratio, agreement on each SOE’s balance sheet reflects its individual circumstances. This also applies to each SOE’s dividend policy. However, in general, the state shareholder will seek the maximum possible dividend consistent with the SOE’s ability to meet its future financial needs. Where an SOE is perceived to have a higher level of financial resources than is necessary for the business, a special dividend may be paid. Frequently, this is at the initiative of the SOE.

R. Hamilton, Crown Companies Monitoring Unit (CCMAU), “State Owned Enterprises Dividend Policy,” correspondence, July 23, 2003.

The return of surplus cash to shareholders is far preferable to bad diversification.

Recent international experience offers many examples of bad diversification.

- One of America’s most successful and famous fund managers has provided a pungent exegesis of ill-considered corporate diversifications, which he refers to as “diworseifications.”¹² (See Box III-5). More recent examples include Worldcom and Tyco. These experiences have encouraged renewed interest of American shareholders in dividends on the grounds that it is better for a company to return surplus cash to its shareholders than to re-invest it poorly in the business.¹³
- European examples of questionable diversification include France Telecom’s debt-financed acquisition of UK mobile phone operator Orange at a very high price, and Vivendi, whose diversification from a predictable but unglamorous water utility to a highly-indebted multi-media empire destroyed shareholder value and nearly bankrupted the company.
- In South Korea, ill-considered debt-financed diversification into highly-competitive and cyclical sectors led to many famous chaebols into distress or bankruptcy: e.g., the Daewoo companies, Kia, Samsung Motors, Hynix, and Hyundai Engineering & Construction.

In all these cases, the return of surplus cash to company shareholders would have been preferable to its use by company management to finance “diworsification.”

¹² These comments are from Peter Lynch, who managed Fidelity’s Magellan Fund from 1977 until 1990. By the time Lynch retired, Magellan Fund had grown to \$9 billion in assets. During Lynch’s management, Magellan posted average annual returns of 29%, which was substantially higher than returns for the S&P500.

¹³ In the US, dividends paid on post-tax earnings are additionally taxed as ordinary income. Recent proposals to lessen this “double taxation” of dividend income has further heightened investor interest in dividends.

Box III-5. Avoid “Diworseifications”

Instead of buying back shares or raising dividends, profitable companies often prefer to blow the money on foolish acquisitions. The dedicated diworseifier seeks out merchandise that is (1) overpriced, and (2) completely beyond his or her realm of understanding. This ensures that losses will be maximized.

Every second decade, corporations seem to alternate between rampant diworseification (when billions are spent on exciting acquisitions) and rampant restructuring (when those no-longer-exciting acquisitions are sold off for less than their original purchase price).

There are so many examples of diworseification I hardly know where to begin. Mobil Oil once diworseified by buying... a retailer in an unfamiliar business that plagued Mobil for years... Mobil blew more millions by paying too much for Superior Oil. Since the 1980 peak in oil prices, Mobil stock has risen 10 percent, while Exxon has doubled. Beyond a couple of relatively small acquisitions, such as Reliance Electric and an ill-fated capital venture subsidiary, Exxon resisted diworseification and stuck to its own business. Its excess cash went into buying back its own stock. The shareholders of Exxon have done much better than the shareholders of Mobil, although new management is turning Mobil around.

Gillette had a spectacularly profitable razor business, which it gradually reduced in relative size as it acquired less profitable operations. If the company had regularly bought back its shares and raised its dividend instead of diverting its capital to cosmetics, toiletries, ballpoint pens, cigarette lighters, curlers, blenders, office products, toothbrushes, hair care, digital watches, and lots of other diversions, the stock might well be worth over \$100 instead of the current \$35... Gillette, too, has made major reforms and lately mended its ways.

General Mills owned Chinese restaurants, Italian restaurants, steak houses, toys, shirts, travel companies, camping goods stores, and footwear.

That's not to say it's always foolish to make acquisitions... We would never have heard of Warren Buffet if Buffet had stuck to textiles... The trick is that you have to know how to make the right acquisitions and then manage them successfully.

If a company must acquire something, I'd prefer it to be a related business, but acquisitions in general make me nervous. There's a strong feeling for companies that are flush with cash and feeling powerful to overpay for acquisitions, expect too much from them, and then mismanage them. I'd rather see a vigorous buyback of shares.

Source: Peter Lynch, *One Up on Wall Street*, (Penguin, 1990), pp. 139, 146-150.

China's large SOEs should each have a formal dividend policy that makes a realistic assessment of alternative uses for surplus cash. China's Hong Kong/New York-listed companies, such as Chalco, seem a good model in terms of process for making decisions on the adoption and implementation of a dividend policy. Ultimately, decisions on dividends should be based on realistic assessments by company directors about the company's business prospects, cash flow projections, debt service capacity, and CAPEX requirements and opportunities. This involves both analysis and business judgment. *Company cash surpluses on which management cannot expect to earn an adequate risk-adjusted return should be distributed to company shareholders.* As a starting point for a more formal approach to dividend policy, China's large SOEs could adopt the working assumption that 100 percent of year-end cash should be returned to shareholders *unless management can demonstrate that the cash is needed to support ongoing business operations or that re-investment of the cash in the business is expected to generate ROCI in excess of some pre-specified "hurdle rate."*

D. Sharing of Sales Proceeds and Liabilities

Some SOE sales will generate sales proceeds. Given that local SASACs are managing local SOE equity on behalf of the entire Chinese people, what sharing of sales proceeds between the local government and the central government might be appropriate? Conversely, proceeds from the sale of some SOEs will not be sufficient to settle all claims on the enterprise – e.g., bank debt, pensions.¹⁴ Thus, should there also be standard arrangements for sharing liabilities between the central and local governments?

Analogous to the broader issue of the sharing of tax revenues and budgetary costs between central and local governments,¹⁵ these issues are beyond the scope of this background paper. But it is useful (i) to comment on appropriate purposes for the use of enterprise sales proceeds and (ii) to highlight the need to address the "localization of benefits-nationalization of liabilities" issue discussed in Section II.

1. Sales proceeds

While OECD experiences have varied, it probably makes sense for China to dedicate enterprise sales proceeds to the reduction of debt or the funding of pension liabilities.

The use of privatization proceeds has varied across OECD countries.

- In some countries such as the UK, Sweden, and Denmark the privatization proceeds have not been ear-marked for any specific purpose and have in effect flowed into the general revenue fund.
- In Germany while privatization proceeds basically flow into the general revenue fund of the budget the proceeds gained through privatization of Deutsche Telekom AG and Deutsche Post AG are earmarked for a limited time (until 2003) to reduce the public

¹⁴ This case refers to an asset sale, not to sale a "going concern" sale in which the new owner assumes all of the enterprise's debts.

¹⁵ World Bank, *China: National Development and Sub-National Finance: A Review of Provincial Expenditures*, Report No. 22951-CHA, April 9, 2002, C. Wong et al.

debt, provided that they are not needed for financing the pension fund of the public servants working for these companies or the former monopoly Deutsche Bundespost.

- In Poland, privatization proceeds have made a significant contribution to implementation of Social Security Reform.
- Similarly in the Czech and Slovak Republics privatization proceeds have been earmarked for specific uses.
- In Greece, the proceeds from privatization have been dedicated to reducing public debt and funding adjustment policies for the affected employees.
- In Italy, the revenues from privatization are set aside in a special Fund and used to purchase government bonds in circulation or their redemption at maturity, thus contributing to the reduction of the debt/GDP ratio.
- In Turkey, the government has used the proceeds for several purposes, including loan repayments, credits for companies, and funding for social assistance supplements.
- In Mexico privatization proceeds were largely used to pay off public debt and also to a lesser extent to fund public expenditure.
- Finally in some cases the proceeds from the sale of stakes, or new share issues have flowed to the state-owned enterprise to pay for its investments and acquisition of assets.¹⁶

2. Control of growth in liabilities

The central government, including SASAC, should explicitly consider approaches to curtailing possible growth in the liabilities that locally-administered SOEs could impose on central institutions. The sale, restructuring, or liquidation of a distressed SOE may force the immediate recognition of outside claims on the SOE – e.g., from workers, trade vendors, utilities, tax authorities, financial institution creditors, pension plans. In many cases, sale proceeds, future cash flows, or assets may not suffice to satisfy these claims. Global experience in corporate restructuring suggests that some claims are more likely than others to be satisfied (or dropped) – e.g., worker severance, trade payables, utilities, and tax liabilities.

Incomplete payment of financial institution credits and pension liabilities is more likely. This, in turn, may create follow-on liabilities for central institutions. For instance, non-payment of bank loans reduces bank capital and may necessitate additional re-capitalization by the Ministry of Finance (MOF). If pension liabilities cannot be fully funded at the local level, the deficit may become a claim on the National Social Security Fund (NSSF). Data are not available to support any detailed analysis.

It appears that the central government faces the following dilemma: either allow local SOE losses to continue and follow-on liabilities to increase or force immediate recognition of all claims on local SOEs through more expeditious sales, restructurings, and liquidations. Central authorities – especially the central SASAC, MOF, largest banks, China Banking Regulatory Commission, and NSSF – should focus on this issue,

¹⁶ OECD, *Privatizing State-Owned Enterprises in the OECD Area: An Overview of Policies and Practices*, Directorate for Financial, Fiscal, and Enterprise Affairs, September 2002, p. 47.

conduct appropriate empirical analyses, and develop approaches to control the “localization of benefits-nationalization of liabilities.”

E. Risk Management

The purpose of risk management is to make it difficult or impossible for a company to take actions – or fail to take actions – that could lead to the destruction of shareholder value or create unacceptable liabilities for shareholders.

Recent corporate disasters around the world illustrate the need for China’s remaining large SOEs to each implement a risk management program appropriate to its line of business and special circumstances. Corporate experience in the U.S., Europe, and Asia over the past five years provides numerous examples of actions that can jeopardize a company’s very existence. Examples include the use of commodity trading or financial derivatives for speculative purposes rather than hedging; investment of cash reserves in speculative equity investments; misappropriation of cash; self-dealing in company stock by corporate insiders; related party transactions, including loans to corporate insiders; use of fraudulent accounting to hide problems; ill-conceived direct equity investments; parent company guarantees on debt repayment by new subsidiaries; and inadequate insurance. A complete risk management program would need to consider a wide range of risks: e.g.,

- Natural hazards;
- Contracting/legal issues;
- Financial operations;
- Misconduct, negligence, or criminality;
- Environmental protection;
- Government regulation;
- Economic conditions;
- Dependence on outside suppliers or vendors;
- Property loss;
- Technology; and
- Workforce

Each SOE’s board of directors should be responsible for ensuring that the SOE is protected, to the extent possible, from excessive risk. Risk management is a specialized area. It would make sense for the board of each large SOE to solicit professional advice on development of an appropriate risk management process.

Compared with non-state companies and private shareholders, SOEs can pose greater risks. Any lack of precision about corporate goals (e.g., return on capital vs. preservation of jobs), lack of creditor recourse to court-supervised reorganization or liquidation, or lack of strong corporate governance would make it easier for SOEs to maintain non-viable businesses or non-sustainable debt through non-payment of claims by trade vendors, financial institution creditors, utilities, and the tax authorities. Thus, SOEs may have greater opportunities to create additional liabilities than could a private enterprise in a similar situation. Other transition governments have attempted to counter this risk

through the imposition of “hard budget constraints” – including requirements for SOEs to repay creditors, pay taxes on time, and remain current on utilities payments.

Careful attention should be given to the imposition of “hard budget constraints” on SOEs as well as private enterprises. Under a hard budget constraint, enterprises must remain current on all payments to workers, suppliers, financial institutions, tax authorities, and utilities. The effectiveness of hard budget constraints depends on the availability of effective remedies (e.g., foreclosure, liquidation, receivership, court-supervised reorganization) for non-payment, on the readiness of all creditors to use available remedies, and on the effective regulation and supervision of financial institutions. The experience of transition countries highlights both the difficulty and importance of hard budget constraints. On the one hand, many efforts by transition governments to impose hard budget constraints have not been particularly effective. On the other hand, ownership transformation – by itself – may not be a sufficient reform. Indeed, experience shows that ownership transformation without hard budget constraints may result in ongoing asset stripping by new owners.¹⁷ Thus, effective programs for the governance of large SOEs and the ownership transformation of small/medium enterprises will also require adequate creditor rights/insolvency systems and adequate supervision of financial institutions.

¹⁷ See William L. Megginson and Jeffrey Nutter, “From State to Market: A Study of Empirical Studies on Privatization,” *Journal of Economic Literature*, June 2001, p. 9, citing studies by Kornai (2000), Berglof and Roland (1998), and Frydman, Gray, Hessel, and Rapaczynski (2000) on difficulty of hard budget constraints. See Edward S. Steinfeld, *Forging Reform in China*, (Cambridge, 1998), pp. 23-38 for examples on the post-transformation importance of hard budget constraints.

IV. Ownership Transformation

This section first looks at China's experience in SOE ownership transformation. Relevant international experience is then reviewed and implications for China are identified.

A. China's Experience

At the outset of economic reform, the Chinese economy was characterized by a fairly simple ownership structure comprising only "two forms of public ownership": state ownership and collective ownership. In agricultural sector, virtually all productions were organized into collectively owned Production Brigades (villages) and People's Communes (townships or groups of villages), while in the industrial sector, state-owned enterprises (SOEs) accounted for 80% of total industrial output, with the remainder shared by urban and rural collectives. By the end of 1990s, the share of state and collective ownership in GDP has dropped down to less than 50 percent.¹ In retrospective, transforming the ownership structure of production organizations has been undoubtedly one of the key components of China's successful reform program. This has been achieved by a combination of strategies: privatization of agricultural production while retaining collective ownership of land; new entry of collectively owned industrial enterprises, in particular, township and village enterprises (TVEs) and their privatization; new entry of overseas and domestic private enterprises; and ownership transformation of existing SOEs.

Past success notwithstanding, China still faces the task of further rationalizing ownership structure of the economy. In particular, ownership transformation of SOEs remains a primary challenge to its economic reform today. It has been explicitly recognized by the authorities that the size of the state sector is still too large that there is a need for "strategic adjustment"; and the equity structure of those SOEs that may remain in the state sector for long needs to be "diversified" by introducing non-state stakes. Ownership transformation of SOEs is a formidable task everywhere in the world. In the transition to a market economy, in particular, it has been proved one of the most difficult challenges for government to handle. It is a fundamental economic issue with strong political and social implications. Even in pure economic terms, it is so easy to get it wrong and so difficult to get it right, as there are many loopholes down the road. The primary concerns are efficiency and equity: how can ownership transformation improve operational efficiency of the firms involved, and how can it be done in a fair and clean manner?

China's SOE reform since 1993 has been marked with increasingly intensive efforts in ownership transformation. In this section, we summarize approaches adopted in the past based on available evidence, which is of anecdotal nature though, and identify key policy issues the government needs to address to further deepen the reform.

¹ International Finance Corporation, *China's Emerging Private Enterprises*, 2000, p. 18.

1. Background

A typical pre-reform SOE was a stand alone factory wholly owned by the state. It was not a corporation, and did not have anything like shareholders, holding companies or enterprise groups. To supervise SOEs more effectively, the Chinese state developed a system of division of labor in exercising ownership rights in SOEs. First, ownership rights were exercised by every level of government, from the national government to provincial, municipal and county governments. Second, ownership rights were shared by a wide range of government and Party agencies. This division of labor is reflected by the concept of “subordinate relation (*li shu guang xi*)”. In the pre-reform regime, a SOE being “subordinated (*li shu yu*)” or “supervised (*zhu guan*)” by a particular level of government would typically mean that the government and party committee at this level exercised the following rights: (i) appoint, monitor, motivate and replace managers; (ii) make key business decisions; (iii) provide finance and claim revenue.

Reform in the 1980s decentralized powers in two fronts. Between government and enterprises, SOE insiders --- managers and employees --- were granted increasingly greater managerial autonomy and allowed to share net earnings with the government in the forms of explicit profit retention and off-salary monetary and non-monetary incomes such as bonuses. This system of managerial autonomy and profit-sharing became significant to ownership transformation that took place later for a number of reasons. First, since in most cases managerial autonomy was only checked by monitoring of Party and government officials, which has been inadequate, incumbent managers were often able to exercise effective control over their firms even before any legal ownership rights were obtained. Second, the flexibility managers had in sharing net earnings with the government in forms of off-salary incomes enabled them and their employees to accumulate some wealth, which can be quite significant in firms with large amount of free cash flow, either as a result of good performance or government finance including bank loans.

Decentralization also took place among central and local governments. A “fiscal contracting system” was implemented in 1980s to make local governments residual claimants, while more decision making power was delegated to them as well. This reform led to the emergence of a system close to what is called “federalism with political centralization” by Blanchard and Shleifer.² Under the fiscal contracting system, better known in China by the nickname of “eating from separate kitchens” as opposed to the pre-reform system of “eating from a shared pot”, local governments entered into long-term fiscal contracts with higher level governments.³ The nature of the contract varied across regions and over time. Despite the complexity, however, there is clearly a common feature that local governments were made responsible for the revenue consequence of

² Olivier Blanchard and Andrei Shleifer, *Federalism With and Without Political Centralization: China versus Russia*, MIT, working paper 00-15, 2000.

³ Yingyi Qian, “The Institutional Foundation of China’s Market Transition,” paper presented at the annual World Bank conference on development economics, April 1999.

their economic policies. This is in essence comparable with the system of managerial autonomy and earning sharing that the government implemented in SOEs.

The fiscal decentralization strengthened local governments' incentives and hardened their budget constraints, in a similar way as the managerial autonomy and earning sharing system did in the case of SOEs. With decentralized decision-making and strengthened incentives, inter-jurisdictional competition was generated,⁴ with heavy costs though, such as local protectionism. In the meantime, political centralization remained in that the Central Committee of the Communist Party of China (CPC) and the central government have been in a strong position to act as a referee and to reward or punish local governments for their performance. All the top local officials are *de facto* appointed by the central authority. To ownership transformation, this implies the following. First, local governments are typically quite concerned with the heavy cost of no action in ownership transformation, in terms of direct fiscal and social cost, as well as opportunity cost in the sense that local development potential is not realized. As a result, inter-jurisdictional competition tends to strengthen the motivation of local government in launching ownership transformation of SOEs. On the other hand, political centralization has meant that no local government official can afford to ignore the ideological and political barriers facing ownership transformation.

These are basically the historical backdrop against which ownership transformation of SOEs took place since 1993.

2. Government policy on ownership transformation

China has had different strategies with regard to ownership transformation of small and large SOEs⁵. A more flexible approach was adopted for small (later medium) ones. As early as in 1987 when the 13th National Congress was held, the CPC permitted "some" small SOEs being sold to employees or contract out to private management. Around 1995, the Party raised the question of the role of state ownership in the "socialist market economy", which was set as the objective of the reform. Since it became increasingly clear that the state was unable to control every sector, every enterprises, it must decide which sectors and which enterprises to control. The answer given in 1995 was a simple one: "grasp the large and let-go the small". Seven methods were prescribed by the Party for implementation of the "let-go small" policy, which include employees buyout and sale to outsiders.⁶ In 1999, the Fourth Plenum of the Party's 14th Central Committee reiterated the "let-go small" policy and extended it to "medium".

For large SOEs, ownership transformation started with corporatization. When contracting responsibility system was still the main reform strategy in the second half of the 1980s,

⁴ Ibid.

⁵ China classified all industrial SOEs into three basic categories: large, medium and small. The current classification was made in 1988 based on sector-specific technical criteria, mainly output or production capacity indicators. For example, a coal mining SOE with annual production of 90-300 tons was defined as medium-sized. "Large" and "small" ones were defined accordingly. See National Bureau of Statistics, *Working Handbook for the Second National Census of Basic Units*, China Statistics Press, 2000, p. 140.

⁶ Other prescribed methods were reorganization, combination, leasing, contracting-out, and joint venture.

China started experimentation of “shareholding system” in a small number of large SOEs. The Third Plenum of the 14th Central Committee of the Party held in November 1993 formally adopted corporatization, known as “building modern enterprise system”, as the main SOE reform strategy. In 1997, the 15th National Congress of the CPC lowered the ideological barrier to ownership transformation by calling for a “strategic adjustment of the layout of the state owned sector” and “exploring multiple forms of public ownership”. In 1999, the Fourth Plenum of the 15th Central Committee further decided to carry out (i) “withdrawal of state” from certain sectors and enterprises to be defined; (ii) “diversification of ownership structure” of most SOEs ; (iii) sales of state owned shares in listed companies to finance social security system reform.

Besides formal corporatization, China opened its SOEs to foreign investors in the form of joint ventures in the early stage of reform. The first law governing joint ventures was enacted by the National People’s Congress in July 1979⁷, which was amended twice in 1990 and 2001. The law allows SOEs to invest their assets into joint ventures, which are run as limited liability companies.

The recent 16th National Congress of the CPC launched a major reform on the state assets management system, which tends to reinforce the autonomy of local government and overcome the fragmentation of the system that has lasted for decades.

Despite all the developments, the Party and the government constantly ruled out “privatization” as one option for SOE reform.⁸

3. Approaches of ownership transformation

Since the starting point was wholly state owned enterprises, ownership transformation always involves introduction of new owners. From this perspective, a clear distinction can be made between insider-led and outsider-led transformation.

Despite the lack of aggregate statistics and systematic survey data, insider-led transformation seems to have dominated the ownership transformation process in the past years. There are several possible reasons. First, ideologically, an enterprise jointly owned by its managers and employees is much closer to the notion of public ownership than any private outsiders ownership. For this reason, insider-led transformation carries lower political risk to officials who implement the reform. Second, as mentioned earlier, insiders, especially managers, have gained substantial control in many SOEs before ownership transformation is initiated. Insider-led transformation that tends to legalize their *de facto* control is easy to gain their support, and therefore, political easier to implement. Third, insider-led transformation is often used as an opportunity to settle explicit and implicit obligations of the state to SOE employees, and often involves less layoffs than outsider-led transformation. This is another reason why it is politically easier to implement. Fourth, many SOEs are in such poor financial condition that it is difficult

⁷ http://www.ceilaw.com.cn/dcd001/owa/cei.fgdetail_query?incode=111705200101

⁸ The latest such statement was made by SASAC Chairman Li Rongrong in July 2003. See <http://www.people.com.cn/GB/jingji/1037/1957726.html>.

to attract outside investors; but these SOEs do not want to be liquidated. As aptly summarized by a local government official, insider-led transformation was designed to address fears of three main players: government officials' fear of making political mistakes, managers' fear of losing power, and workers' fear of losing jobs.

The result of insider-led transformation in small and medium SOEs is typically a limited liability company with managers and employees as its shareholders.⁹ Sometimes, a small fraction of shares is distributed to outsiders who have close link with the firm or insiders, such as retired employees or local officials. In the so called "first round transformation," which were very common during 1995-1998, shares were often distributed more evenly among managers and employees. This was later found not desirable. In the subsequent "second round transformation", actions were taken to increase the concentration of shares with top management, by management's purchase of old shares from workers or new shares. Those that carried out ownership transformation in a later years typically skipped the first round and went directly to a model of concentrated managerial ownership.

In large and some medium SOEs, the wealth constraint of insiders are more binding. As a result, they can only hold a minority stake in many transformed SOEs. Corporatization is often the time when minority shares are allocated to insiders. Shares can also be given to managers and employees as part of their bonus. For example, a large SOE was allowed by the municipal government to distribute up to 25 percent of the increased value of state ownership stake in the firm to managers and employees in form of shares. The company managed to increase the share of insiders from zero in 1996 to 42 percent in 2001. In recent years, as managers become stronger in financial wealth, management and employees buyout has become increasingly common. In the latest wave of MBOs that took place after the 16th National Congress of the Party, which signaled strengthened management of state assets, around 15 state controlled listed companies have been bought out by their management. The usual practice is for the management to create a private company, which comes back to acquire state shares of the target company. For example, a Foshan based investment company acquired from the second largest shareholder 29.46 percent of shares of a listed company Foshan Plastic. The investment company turns out to be owned by senior managers of Foshan Plastic. Most recent MBO cases involve a transfer of 20-25 percent shareholdings in listed companies to management, with prices typically set at the level of book value of net assets per share.

Wealth constraint is a major difficulty in most insider-led transformation, although more severe in large firms than in small firms. A variety of methods has been developed to get around this constraint.

Leasing. Assets with large value, such as land, key machineries, can be excluded from balance sheet when the shares of a SOE is sold to insiders. The transformed firm is

⁹ The "joint stock cooperative," in which only insiders were granted rights to buy shares, was popular in the 1990s. there is no law or central government regulation governing joint stock cooperatives. In many cases, these have been transformed into limited liability companies after a period of operation. See Stoyan Tenev and Chunlin Zhang, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*, chapter 3, World Bank and International Finance Corporation, 2002.

allowed to use these assets by signing a leasing contract with the government. In some cases, assets of the whole SOE are leased to management or insiders with a clause in the contract stating that after paying the specified rent for a certain number of years, the leasees receive legal ownership of the assets.

Installment. The insiders are permitted by the government to pay the full price in installment, often based on expected stream of profit of the transformed SOE.

Assets spin-off. This is the most commonly used method to address social obligations of the state to employees. The idea is to use part of the state ownership stake in the firm to finance these obligations. For example, in one industrial city, the practice was to deduct from net state assets the following three: a sum for all redundant workers at the level of RMB8000 per person; a sum for all senior retirees at the level of RMB6000 per person; a sum for other retirees at the level of RMB12000. Only the remaining part of state ownership stake is sold to buyers. Due to flexibility in estimating these parameters, this process can be utilized to lower down the sale price to fit the purchasing capacity of insiders.

Assets evaluation. As a main safeguard against possible loss of state assets, sale prices are determined based on results of assets evaluation authorized by local authorities, typically local Administration of State Owned Assets. However, some stories suggested that local government are often able to exercise its influence on evaluation results.

Debt assumption. The more a SOE is indebted, the less is the value of state ownership stake which the buyers need to pay for. Therefore, a critical step to get around the wealth constraint is to get permission from creditor banks to assume existing debts. In the extreme cases, buyers obtained the ownership of the firm completely by assuming existing liabilities, the so-called “zero-price purchase”.

Special credit. In recent MBO transactions, more sophisticated financial vehicles have been created to enable managers overcome the constraint of their personal wealth (see Box IV-1). A private, and often informal, trust fund is created to collect money from a group of individuals or institutions and lend to managers. Some suspects the money may have come from large banks somehow.

Box IV-1. The MBO of Suzhou Fine Chemical Group

A Suzhou-based chemical SOE, Suzhou Fine Chemical Group, was privatized through MBO in May 2003. The Chairman and CEO acquired 90% and 10% of the Group, respectively, from Suzhou Financial Bureau for a total of RMB 125 million. The purchase was fully financed by a loan from a “trust fund,” with all shares pledged as collateral. A Suzhou accounting firm performed an assets evaluation prior to sale. The book value of the Group was set at RMB 307.7 million. However, RMB 188.9 was “spun off” (reduced) as compensation for non-performing assets and settlement of the status of employees. The final price resulted from application of an MBO discount as stipulated by municipal government regulation. The Chairman and CEO are expected to repay the loan to the trust fund in 3 years with company profits, which need to reach RMB 72 million per year. In 2002, the Group earned RMB 37.8 million. Extra income is expected in 2005 from a piece of real estate that the Group just acquired with support from the municipal government. Employees participated in the transaction by subscribing to interest-bearing trust fund “units.” From five alternative ways to participate in the transaction, 90% of employees chose this trust fund option.

Source: *21st Century Economic Herald*, May 19, 2003.

Outsider-led transformation takes many forms. To the extent that the SOE has positive net worth, a convenient classification can be made along two dimensions: if outsiders acquire existing shares or new shares, minority stakes or controlling stakes, as shown in Table IV-1. Selling minority stakes of existing shares to outsiders is not common. The other three forms (majority sale of existing shares, IPOs, joint ventures) are probably the main ways of outsider-led transformation.

Table IV-1. Outsider-Led Transformations

	Existing shares	New shares
Controlling stakes	Sale to domestic private firms and individuals	Some Joint Ventures
Minority stakes	Not common	IPOs, some joint ventures

Joint venture. As noted earlier, China opened its SOEs to foreign investors in the form of joint venture at the very beginning of the reform and opening up. In 1979-94, 140,899 joint ventures were created in China, representing 53 percent of actual FDI inflow¹⁰. In 2001, joint ventures still accounted for 36 percent of actual FDI¹¹. It has been a gradual process for China to accept foreign investors control in joint ventures. Joint ventures in the 1980s were more often controlled by the Chinese parent SOEs, and wholly foreign owned firms were less important in terms of shares in total FDI. Changes took place in 1990s as new joint ventures were more often controlled by foreign investors and wholly

¹⁰ Li Langqing edited, *Basic Knowledge of China's Utilization of Foreign Capital*. Beijing: China Foreign Trade Press. P89.

¹¹ *China Statistical Yearbook 2002*. Table 17-14.

foreign owned firms became the largest part of FDI.¹² When a Chinese SOE invests most of its performing assets into a joint venture controlled by foreign investors, fundamental ownership transformation takes place, as it is likely that the way the firm operates will be changed in some fundamental ways. In legal terms, however, this is not exactly a privatization, as the old SOE remains a legal entity, together with poorly performing assets, redundant employees, bad debts, etc.. In those more successful cases, the old SOE uses its earnings from the joint venture to finance the restructuring of the old “shell”. China’s automobile industry is now completely dominated by joint ventures with major international manufacturers. In the case of Shanghai Automobile Group, the mainstay of its second tier operational companies are around 60 joint ventures, which were typically created by carving out better performing assets from old SOEs. Since 1995, the Group has digested about 20 such SOE shells left after a joint venture transformation, with about 10 remained in 2003.

IPOs. If joint ventures have been a vehicle for SOEs to attract equity capital from overseas investors, IPOs is the one designed for domestic private investors. The basic idea is essentially the same: an old SOE carve out its better performing assets to create a subsidiary through a process of “packaging”, and invite private investors contribute additional capital by issuing new shares. The first important difference is that while overseas investors are mostly firms, including many top multinationals, domestic private investors are mostly individuals. As a result, corporate control stays with the state while private equity capital enters into the firm. The non-tradability of state owned and legal person owned shares provides further assurance that state-owned shares are not sold to private investors in the market.

However, over time, the ownership structure of listed companies changes gradually. The general direction is a decline of state ownership. This usually takes place as non-state investors contribute additional capital to acquire new shares. One analysis of 2000 data found that companies with highly concentrated ownership tend to be more recent issuers on the stock market, while older issuers tend to have more diverse ownership.¹³ For example, among the 110 listed companies that have the most concentrated ownership structure,¹⁴ 74 percent had been listed during the prior four years. By contrast, among 303 companies with more dispersed ownership structure,¹⁵ only 33 percent had been listed during the prior four years. Similar process took place in some non-listed SOEs where private individuals or firms become shareholders by contributing new equity capital. By increasing their investments, transfer of control may occur in a later stage.

Sale to domestic private investors. This category has some variants. The simplest case is the sale of small SOEs to private firms or individuals. Despite the perceived dominance of insider-led transformation, this kind of sales accounted for probably a quite large

¹² The share of wholly foreign-owned firms in actual FDI inflow increased from 3.5% in 1984 to 37% in 1990 and 62% in 2001 according to official statistics.

¹³ Chunlin Zhang, mimeo, 2001.

¹⁴ The largest shareholder owns more than 68% of shares and the next 4 largest shareholders own <5% as of mid-2000.

¹⁵ The largest shareholder holds 15-27%, while the next four largest shareholders hold more than 40%.

fraction of all ownership transformation cases. There are evidence suggesting that sales to outsiders has become increasingly more important over the past few years. A survey in six cities conducted by an IFC team found that while sales to outsiders accounted only for 7.7 percent of all transformation cases, the percentage had risen to 23.5 percent in 2002 (see Box IV-2). As in the case of sales to insiders, sale of a small SOE to outside private individuals also involves a long process in which social issues are dealt with. In principle, government agencies that implement the transformation are supposed to present to workers a quite specific transformation plan including arrangements related layoffs, pension, medical insurance, housing, and their status as state employees. Transformation is not supposed to proceed until workers congress approves such a plan. Assets evaluation is conducted to provide basis for determination of sale price. Buyers may also allowed to pay the price in installments. Some buyers may manage to obtain credit from banks or other firms, institutions or individuals.

Box IV-2 Private Sector Participation in “ Gaizhi”

Among the six interviewed cities, the private sector was very active in participating in gaizhi in Tangshan, Chengdu, Guiyang, and Hengyang. Open sales and leasing consisted of 33.3%, 42.9%, 36.6%, and 55.1% in those cities, respectively. Many of the sales and leases were between an SOE and a private company.

Private businessmen accumulated wealth in the coal mining industry in Tangshan. As the central government began to limit the development of small coalmines, these private mine owners started to look for new areas of investment. SOE Gaizhi gave them a chance. Many SOEs in Tangshan had difficulty to continue their operations, and some of them had stopped production for several years. One example is a factory producing mining machinery. This firm had stopped production for three consecutive years and had accumulated huge amount of debts and backlogs of wages. The local government found a private businessman who was willing to purchase the factory with the condition that half of the 1,000 workers would be laid off. To save the factory, the government agreed on the condition and sold the factory to the private businessman with a substantial discount. In 2002, most of Tangshan’s 15 gaizhi SOEs were sold to private businessmen.

In Hengyang, leases instead of sales were more frequently used. One typical example is an alcohol factory. This factory had a history of 45 years and produced industrial alcohol. Starting in as early as 1992, the factory had begun to rent out part of its buildings and equipment to employees to produce byproducts such CO₂. Till 2001, this factory had been trapped in deep debt, with its debt/equity ratio being 200%. In June 2002, a private businessman rented most of the factory facilities and started new production. Sales were doubted in two months after the lease began.

Selling or leasing to an outside private firm has increasingly become a top choice of gaizhi for local governments. This has happened for three reasons. First, private firms offer cash payments to buy an SOE so the government is able to settle layoff workers relatively easily. Second, private purchases exempted the government of future obligations to the workers. And lastly, pure private firms perform better than mixed-ownership firms.

Source: International Finance Corporation, *Restructured SOEs (“ gaizhi”) in China*, draft.

The more sophisticated case involves the sale of state owned shares in listed companies to private firms or individuals. All sales of state-owned shares of listed companies to nonstate investors require Ministry of Finance (MOF) approval, which was tightly controlled for many years until the abortion of the “state share selling down program” in 2002. On August 15, 2002, a proposal of selling controlling shares of a company in Neijiang city, Sichuan province to three companies, including one nonstate, was approved by the MOF, which has been taken as marking a turning point of government policy. It is common for private companies to acquire controlling stakes from the state as one way to gain access to the stock market, so-called “buy a shell to get listed”.

Ownership transformation can also take place in insolvent SOEs. In addition to liquidation, debt equity swap followed by sales of the equities may also result in a non-state ownership of a company. The first case of sale of converted equity by a financial assets management company (AMC) took place in Xinjiang on December 11, 2000. A private company (Guanghui) acquired shares of the October Tractor Company held by Huarong AMC after a debt/equity conversion. The shares were sold for a 5% premium above face value (of the debt?) and the private company, which has a listed subsidiary on Shanghai Stock Exchange, obtained a 69 percent controlling stake in the tractor company. This is the first case of ownership transformation resulting from a debt/equity conversion. In another transaction concluded by Cinda AMC concluded in Bengbu city, Anhui province, a 70 percent stake in a former state-owned power generating company was transferred to two US companies.

4. Policy challenges

Competition. The primary challenge the government may need to address is to increase competition in the ownership transformation process. All the insider-led transformations are marked with a lack of competition. Insiders are virtually protected from competition from outsiders. In cases where outsiders were introduced to bid against insiders, they were often handicapped by disadvantages in terms of access to information and local connections. Outsider-led transformations are conducted with more competition, however, it is still not clear if the degree of transparency and fairness is adequate. A lack of competition may have negative impact on both efficiency, by missing the most capable new owner, and equity, by failing to obtain the best sale price for citizens.

Treatment of SOE managers. In China as in some other transition economies, SOE managers constitute a strong interest group. As incumbents, SOE managers possess strong advantage in competing with outsiders, so strong that in outside competitors are effectively excluded from the very beginning of the transformation process. On the other hand, SOE managers are generally constrained by their lack of personal wealth. For relatively large SOEs, they can hardly acquire all the ownership stakes. This creates the typical model of managerial ownership in which managers have de facto control over the firm but do not bear the full consequence of their action. The potential corporate

governance issues together with the exclusion of competition from outsiders may render the transformation a failure. The government needs a balanced policy to ensure a fair treatment of SOE managers and in the meantime efficiency and equity of the transformation process are realized.

Treatment of employees. While it is practically easier to settle obligations to employees through the transformation process, the merits of shareholding by employees are questionable. When employees hold minority shares, they are put in a vulnerable position as shareholders in their relation to managers, as their jobs are in the hands of managers as a kind of “hostage”. When employees become majority shareholders, post-transformation restructuring becomes a challenge. Employees as a group often lack the experience, management skill and financial strength to restructure relatively large and technically complex firms. With a better developed social security system, policies should be devised to handle social obligations to employees separately from selecting the new owners.

Protection of state assets. Loss of state assets is often the most sensitive issue in ownership transformation, be it real or perceived. The government needs to install a set of institutions that not only safeguards state assets against any possible real loss, but also convinces citizens that this is indeed the case. Open competition, high degree of transparency, independent assets evaluation may be some of the key components of such institutions.

Creditors’ role in ownership transformation. Given the high portion of SOEs that are insolvent, the role of creditors in causing and shaping the direction of ownership transformation is of great importance. For various reasons, creditors have been in a weak position in dealing with their SOE debtors. There is a great deal of potential for improvement in this regard, if appropriate government policies are put in place.

B. International Experience

Over the past two decades, OECD countries have sold about \$750 billion worth of state-owned assets. The transition countries of Central Europe have sold a massive volume of state assets since 1990. From this broad range of experience, it is reasonable to draw relevant conclusions in terms of sales program goals; institutional framework; policies on such key issues as treatment of labor and treatment of insiders; preparations for sale, including enterprise valuation and pre-sale restructuring; conduct of sales; and post-sale obligations and support.

1. Goals

Sales objectives should be clearly identified and prioritized at the start of the process, in order to highlight tradeoffs and guide the preparation and conduct of the sale. While emphases have varied from situation to situation, sales objectives have included the following:

- Fiscal – ending subsidies to loss-making SOEs, generating sales proceeds, reducing debt, and realizing greater tax revenues from improvements in corporate efficiency and performance;
- Investment – attracting private capital, from foreign and/or domestic investors, and giving enterprises the flexibility to pursue long-term investment plans;
- Improvements in enterprise efficiency and performance;
- Increases in competition; and
- Support for capital market development, through public share offerings

For example, the U.K and Dutch privatization programs in their early stages and later Italy and Spain focused on fiscal objectives. Australia sought increases in enterprise efficiency and competition. Finland pursued enhanced competitiveness in response to globalization and capital market development. Germany’s goals included capital market development, a reduced role for the state, and increased competitiveness. Objectives may conflict. For example, while sale of a state monopoly through a trade sale would likely maximize fiscal revenues, it would not support capital market development or enhance competition. “Clear identification of policy priorities early in the process helps the government identify potential conflicts and tradeoffs, and...helps guide the choice of privatization methods...Therefore, it is critically important to set out the objectives and prioritize them as much as possible in order to ensure that potential tradeoffs are fully understood at the outset.”¹⁶

2. Institutional Framework

Successful enterprise sales programs achieve reasonable efficiency while maintaining public confidence. Key considerations include the program’s emphasis on transparency; centralization or de-centralization of sales authority; role of SOE management and employees; and involvement of outside advisors.

Transparency is essential for maintaining public support for enterprise sales and for forestalling future charges of corruption. In OECD countries, “often the selling price is a source of criticism...perceptions of conflict of interest and corruption charges can severely undermine the credibility of the privatization process with potential investor and erode public acceptance.”¹⁷ In the transition economies of Central Europe, enterprise sales have almost always been politically contentious. “Officials have frequently been accused of selling the ‘family silver’ too cheaply or to political insiders and have often been investigated following a change in government.”¹⁸ Necessary transparency has resulted from the following measures:

- Development and publication of clear and comprehensive laws, regulations, and procedures to govern enterprise sales;
- Wide publicity of upcoming enterprise sales and dissemination of relevant and reliable information on enterprises to be sold;

¹⁶ OECD, *Privatising State-Owned Enterprises in the OECD Area: An Overview of Policies and Practices*, Directorate for Financial, Fiscal, and Enterprise Affairs, September 2002, pp. 9-10, 24-5.

¹⁷ Ibid, p.36

¹⁸ World Bank, *Privatization Practice Note: Europe and Central Asia Region*, March 2003, pp. 9-10.

- Reliance on a competitive sales process – e.g., public auction, tender, or share offering;
- Equal treatment of foreign and domestic investors, including both insiders and outsiders;
- Development of professional valuations and use of professional advisors (e.g., accountants, lawyers, financial advisors) for particularly large or important enterprises;
- Rules to avoid or disclose real or potential conflicts of interests among officials, advisors, SOE management and employees, and potential investors; and
- Publication of results from enterprise sales and oversight by an appropriate public body.

OECD experience “shows that open, transparent, and competitive processes generate better outcomes in terms of price and quality of buyers...The gains in terms of better outcomes and...credibility generally outweigh the costs of running competitive processes.”¹⁹

A centralization of decision-making authority for enterprise sales is most appropriate for countries with a large portfolio of enterprises. Some countries have successfully left decision-making to sectoral ministries or split authority between the relevant sectoral ministry and the finance ministry (e.g., Denmark, Switzerland, Japan, Great Britain). This approach is more appropriate in simple situations – e.g., only a few enterprises to sell, no broad public policy issues on such matters as labor displacement and settlement of creditor claims. Relatively few OECD countries have taken a decentralized approach. Centralization of authority – e.g., within a particular asset management body – facilitates a coordinated response to broad public policy issues, timely decision-making, and development of expertise. The authority for organizing and concluding SOE sales has been centralized – either in the finance ministry or a dedicated privatization administration – in France, New Zealand, Portugal, Mexico, and Turkey.²⁰ Other transition economies have tended toward a centralization of authority, with appropriate adjustments for geographical dispersion. In East Germany, the *Treuhandanstalt* wielded broad authority in selling or liquidating 12,000 industrial enterprises (with board consent required only for particularly large transactions) and resolving creditor claims.²¹ In Russia, state property committees (GKIs) had broad authority to organize SOE sales, with provincial or municipal GKIs responsible for small/medium enterprises and the national GKI responsible for large SOEs. Poland followed a similar national/provincial division of labor for the sale of large vs. small SOEs. In Czechoslovakia, the sectoral ministries had a role in preparing privatization plans. But key decisions on SOE valuation, sale method, pricing, selection of purchaser, environmental indemnification, and negotiation of other terms (e.g., worker retention, post-purchase investment) were made by the

¹⁹ OECD, p. 37.

²⁰ Ibid, pp. 27-29.

²¹ Board consent was required for sales of a company with net assets exceeding DM 100 million, revenues exceeding DM 300 million, or more than 2000 employees. Despite almost DM 67 billion in sales proceeds, the need to pay off SOE creditors left the Treuhand with debts of DM 450 billion. These debts were financed through bonds to be paid off over 30 years. Roland Czada, “The Treuhandanstalt and the Transition from Socialism to Capitalism,” p. 9-13, Fernuniversitat Hagen, 1996.

Ministry of Privatization, usually on the recommendation of its advisors. Particularly large sales also needed approval by the Council of Ministers.

SOE management must support sale preparations, in terms of information disclosure. But other involvement should be avoided in order to avoid conflicts of interest. For an SOE to be sold as a “going concern” (versus a sale of its assets), SOE management must provide complete and accurate information of interest to potential buyers – e.g., regarding current business operations; receivables, inventory, and other assets; revenues and operating expenses; and all debts and liabilities. SOE management must also cooperate with efforts by potential buyers to conduct “due diligence” of the SOE’s business and finances. Experience since 1990 from Central Europe, however, shows that involvement of SOE management in valuation, selection of sales method, or negotiation is a conflict of interest and a potential turn-off to potential buyers. Such involvement by SOE management should be avoided.

At least for large or complex sales, outside advisors should be retained to perform key tasks. Key tasks may include restatement of financial statements to international standards, enterprise valuation, preparation of an information (sales) memorandum, investor search, negotiation, management of a public share sale, or resolution of legal or environmental issues. Appropriate situations include public share sales or sales to a foreign investor. Most OECD privatizations have involved outside advisors.²² The definition of “large” may vary from country to country. In the transition countries of central and eastern Europe, foreign advisors were used for transactions as small as \$0.5-3.5 million.²³ Some transition governments have not wanted to retain outside advisors to save on fees (which may amount to 5% of transaction value) or to follow their advice. This has detracted significantly from the transparency of such countries’ privatization programs, the quality of buyers, and sales proceeds.²⁴ Outside advisors can enhance the transparency of an enterprise sales program and protect government officials from criticism over sales proceeds and buyer selection (or at least deflect criticism to professional advisors, who may have “deep pockets” and who can be sued for any failure to act professionally and with due care). It is in the interest of the selling agency, however, to show care in the selection and management of outside advisors.²⁵

3. Policy Choices

²² OECD, p. 33.

²³ Examples include \$2.9 million sale of metals company and \$500,000 sale of porcelain company to local investors in Poland; and sales of construction company (\$3.5 million), building materials company (\$1.7 million), appliances manufacturer (\$3.2 million), and chocolate producer (\$3.2 million) to foreign investors in Czechoslovakia. World Bank, *Selling State Companies to Strategic Investors: Trade Sale Privatizations in Poland, Hungary, the Czech Republic, and the Slovak Republic*, Volume 2, Case Studies, 1995. International investment banks will not be interested in small transactions, but accounting firms or local advisors can still play a useful role.

²⁴ World Bank, *Privatization Practice Note: Europe and Central Asia Region*, p.14.

²⁵ Advisory mandates should be carefully designed, in order to manage potential conflicts – e.g., between the strategic advice, valuation, and transaction functions. Advisors should be selected through a competitive process. World Bank, *The Case-by-Case Approach to Privatization: Techniques and Examples*, March 1998.

Already discussed one key policy choice – use of privatization proceeds in Section II. The biggest other policy choice has to do with the desirability of bringing in outside investors. Basic decisions on the outsider vs. insider issue affect policy choices on the treatment of foreign investors and the treatment of employees.

The enterprise preparation and sale process should be designed to facilitate the sale of concentrated ownership shares to outsiders, including foreign investors. In the transition countries of Central Europe, new owner identity and ownership structure has had a major effect on post-sale performance of former SOEs. Empirical studies have consistently shown that concentrated ownership is better than widely-diffused ownership, that “outsiders” tend to be better than “insiders,” that new managers tend to be better than old managers, and that foreign buyers tend to be better than domestic buyers in promoting post-sale enterprise restructuring and performance improvements (see Table IV-2).

Table IV-2. Summary of Empirical Studies of Privatization in Central/Eastern Europe

Study	Description	Main Findings
Claessens, Djankov, and Pohl (1997)	Examines effect of ownership structure on performance of 706 Czech firms privatized 1992-95.	Privatized firms prosper, mainly because of resulting concentrated ownership. Increases in ownership concentration lead to higher profitability & market valuation.
Pohl, Anderson, Claessens & Djankov (1997)	Compares restructuring by >6300 private firms and SOEs in 7 Central European countries, 1992-95.	Privatization dramatically increases restructuring likelihood & success. A firm privatized for 4 years increases productivity 3-5 times more than a similar SOE. Concentrated ownership leads to more restructuring than dispersed ownership.
Smith, Cin & Vodopivc (1997)	Examines effect of foreign & employee ownership on 22,735 firms in Slovenia.	Value-added is higher with foreign-owned than with employee-owned firms.
Dyck (1997)	Examines Treuhand’s privatization of East German SOEs, include emphasis on speed, minimal pre-sale privatization, and “open” sales.	Open sale process that is open to non-local buyers and that allows management change is most likely to improve firm performance.
Frydman, Gray, Hessel & Rapaczynski (1999)	Examines effect of ownership structure on performance of 128 privatized firms & 90 SOEs in Czech Republic, Poland, and Hungary.	Privatization “ works,” but only when firm is controlled by outside owner. Outside owner adds significantly to earnings and profitability growth. Gains not necessarily from workforce cuts. Insider-controlled firms are much less likely to restructure.
Weiss & Nitkin (1998)	Analyzes effects of ownership by investment funds on 125 privatized Czech firms, 1993-95.	Concentrated ownership by a large shareholder, other than an investment fund, is associated with significant performance improvements. Concentrated ownership by investment funds did not improve firm performance.
Claessens & Djankov (1999a)	Studies effect of new management on profitability and labor productivity of 706 privatized Czech firms, 1993-97.	New management is associated with significant improvements in profit margins and labor productivity, especially if new managers are selected by private owners. New managers appointed by National Property Fund also improve

		performance, but not by as much.
Claessens & Djankov (1999b)	Examines relationship between ownership and profitability & labor productivity for 706 privatized Czech firms, 1992-97.	Concentrated ownership is associated with higher profitability and labor productivity. Foreign strategic owners and non-bank sponsored investment funds improve performance more than bank-sponsored investment funds.
Frydman, Gray, Hessel & Rapaczynski (2000)	Looks at 216 firms – 31% SOEs, 43% privatized, 26% private – in Czech Republic, Hungary, & Poland to examine effect of “hard budget constraints.”	Privatization of an SOE in sale to outsiders adds significantly to revenue growth. Threat of hard budget constraint on SOE falters, since governments are unwilling to allow SOEs to fail.
Frydman, Hessel & Rapaczynski (2000)	Looks at 506 manufacturing firms in Czech Republic, Hungary & Poland to assess effect of outside ownership on innovation.	Privatized firms and SOEs pursue similar types of restructuring. But product innovation by outside investors is significantly more effective, in terms of product innovation, than other types of ownership. Concludes that innovation by outsider-owned firms is due to incentive effects of privatization.
Lizal, Singer & Svejnar (2000)	Looks at 635 firms to assess effect of SOE break-ups and spin-offs.	Among small and medium firms, both the spin-off and the parent showed immediate gains in profitability and efficiency.

Megginson and Nutter, Table 6.

A survey of 125 empirical studies of enterprise restructuring in the transition economies of Central Europe, the former Soviet Union, Mongolia, and Vietnam finds that privatization is strongly associated with enterprise restructuring and more enterprise restructuring results from sale to foreign investors (versus domestic investors), to dominant shareholders (versus a large number of dispersed shareholders), to outsiders (versus insiders), and to new managers (versus existing managers). In both Central Europe and the former Soviet Union, there is no evidence that stronger managerial incentives lead to more restructuring. New management is much more likely to lead to restructuring.²⁶

SOE insiders (i.e., management and workers) should be treated fairly, but should not be allowed to delay any sale and – if possible – should not receive any preferences in sale of the SOE. Management and workers sometimes oppose SOE sales because of concern about possible loss of employment, job security, or civil service status. In many OECD countries, labor unions have opposed privatization. But, cognizant of the need for reform, labor unions have adopted the pragmatic approach of seeking to be consulted and to participate in implementation of the labor adjustment. Experience from various OECD countries highlights the need for early consultation – e.g., on reasons for the sale and measures to address insider concerns. Government and labor unions have found it useful to adopt a standard framework for consistent treatment of common concerns (e.g., change in status, change in pensions).²⁷ But giving insiders any control or veto over an SOE sale or any preferential treatment should be avoided if at all possible, as illustrated by recent experience in the transition countries of Central Europe and Russia. Legislation in Poland and Hungary requiring worker approval of enterprise transformations was a

²⁶ World Bank, *The Determinants of Enterprise Structuring in Transition: An Assessment of the Evidence*, September 2000.

serious impediment, in contrast to Czechoslovakia. In Russia, the political requirement to sell 40 or 51 percent of enterprise shares to insiders has set back post-sale restructuring and corporate governance for years, if not decades (Box IV-3).

Box IV-3. Preferences for Insiders: Four Transition Economies

Poland: Transformation of an SOE into commercial form required approval of the workers' council which, upon transformation, would be abolished and replaced by a supervisory board. The government tried to offset this loss of influence by allowing workers to buy shares in the privatized company at one-half of book value. Examination of company cases shows, however, that workers bought shares only when they could immediately re-sell them to a strategic investor. By end-1993, 5,500 SOEs out of an original 8,440 had *not* been corporatized. These un-transformed SOEs could not be sold even if an investor was ready and willing.

Hungary: In the 80% of the SOEs that were "self-managed," enterprise councils dominated by management had to approve any transformation and sale. The law provided for 20 percent of sale proceeds to be go to management as an incentive. Nonetheless, in 1992, the government enacted legislation to force all remaining SOEs either to corporatize themselves or to allow the State Property Agency to complete the process. As of end-1993, fewer than 200 of 1,848 SOEs had been transformed.

Czechoslovakia: Initial approvals from SOEs were not necessary. All SOEs were required to propose a plan for privatization. By August 1994, 75 percent of medium/large SOEs had been transformed and privatized.

Russia: Workers could acquire 40% of an SOE's shares at 20% of book value or purchase 51% at 170% of book value. This compromise, which was deemed necessary because of the government's interest in rapid privatization for political and macro-economic reasons, permitted the privatization of 16,500 medium/large SOEs within about 2 years. But insiders ended up with 2/3 of the shares in about 2/3 of the SOEs sold, with consequent poor effects on enterprise restructuring and corporate governance.

World Bank, *Selling State Companies to Strategic Investors*, pp. 13-4; the State Committee of the Russian Federation for the Management of State Property, *Annual Report 1992*, p. 8; World Bank, *The World Bank, Privatization and Enterprise Reform in Transition Economies: A Retrospective Analysis*, 2002; Joseph Blasi, et al, *Kremlin Capitalism: Privatizing the Russian Economy*, Cornell, 1997.

Ideally, the sale process should not require approvals from SOE insiders. Experience shows that financial incentives may not suffice to elicit insider approvals. Given the benefits that outside investors/managers can bring to enterprise transformation and restructuring, it would be a mistake to exclude outside bids. Insiders may be given a preference (e.g., a discount) in bidding for SOE ownership, but only if absolutely necessary.²⁸

While a country may reasonably exclude or limit foreign investment in strategic sectors, foreign investors should not be disadvantaged in seeking to invest in "open"

²⁷ OECD, pp. 45-6.

²⁸ World Bank, *Eastern European Experience with Small-Scale Privatization*, a collaborative study with the Central European University, April 1994, p. 9.

sectors. A large number of OECD countries have no restrictions on foreign ownership: e.g., Czech Republic, Germany, Hungary, Poland, Slovakia, and Sweden. As noted earlier, foreign investment can be shown to have strengthened enterprises in Central Europe and the former Soviet Union. Some OECD countries have dropped restrictions, for example, Portugal in 1990 and France in 1996. Some countries have specific restrictions or may apply case by case restrictions, for example, Australia, Mexico, or South Korea's 49 percent limit on foreign ownership of Korea Telecom.²⁹ U.S. law limits foreign ownership of U.S. airlines and Defense Department approval is required for foreign investment in a defense contractor. In countries concerned about foreign investors overwhelming local investors (e.g., Mexico), responses have been to encourage joint ventures; reserve a separate *tranche* of shares in a public offering for local investors; or combine share sales to strategic investors with public share offerings. A recent assessment finds that such "mixed" approaches have been underutilized in the former Soviet Union. In these countries, powerful local groups have sought to block foreign competition in order to gain preferential access to enterprise ownership. As a result, former SOEs have received less technology, investment, managerial know-how, and market access and these privatization programs and governments have been dismissed as collusive and corrupt.³⁰

4. Preparations for sale

Preparations for an SOE sale may require decisions on whether to do any pre-sale restructuring, how to value the SOE, and how to attract potential buyers.

Pre-sale restructuring of SOEs should be minimized. The appropriateness of pre-sale restructuring depends on the size and condition of the enterprise and the sales method. For small and medium SOEs, experience indicates that these should be sold "as is," at the best price possible, and as quickly as possible.³¹ In OECD countries, sale of small and medium SOEs typically involves just minor legal and financial restructuring.³² It is probably worthwhile to lay off redundant labor. But new capital investments should be left to the new owners. Because new owners will restructure the former SOE according to their particular business strategy, they are unlikely to pay extra for pre-sale restructuring; the seller cannot count on recovering pre-sale restructuring costs.³³ In Mexico, for example, it was found that pre-sale labor-cutting tended to increase the value of the company but that pre-sale capital investments actually tended to reduce the

²⁹ OECD, pp. 44-5.

³⁰ World Bank, *Privatization Practice Note: Europe and Central Asia Region*, and Ira Lieberman and Rogi Veimetra, "The Rush for State Shares in the 'Klondyke' of Wild East Capitalism: Loans-for-Shares Transactions in Russia," *George Washington Journal of International Law and Economics*, Vol. 29, 1996, p738. In one notable case, through a non-competitive process, a Russian bank acquired 38% of the shares in Norilsk Nickel – which had reported profits of \$2 billion – for a \$170 million loan.

³¹ World Bank, *Privatization: The Lessons of Experience*, 1992.

³² OECD, p.39-40. Examples could include change of business form or the seller's assumption of some or all of the SOE's debt.

³³ World Bank, *Privatization: The Lessons of Experience*.

company's value.³⁴ An analysis of sales to strategic investors in Central Europe agrees "that, although enterprise restructuring was needed and may have discouraged some investors, restructuring could (and should) be left to private investors." At most, restructuring might be undertaken in response to investor proposals. If an enterprise is particularly large or distressed, no investor may be interested in the entire enterprise. In such cases, governments should be prepared to accept bids for pieces of the enterprise.³⁵ Pre-sale restructuring may be more appropriate for sale through a public offering, since there may be no dominant (e.g., "strategic") shareholder after the sale. Even in such cases, "pre-privatization restructuring should be limited to balance sheet strengthening and organizational changes such as closures, workforce reductions, and transfers of social services. Technology changes, capital investment, and new purchases should be left to the new owners."³⁶

For sale of small SOEs, it is most appropriate to focus on the transfer of real estate. A great many small SOEs were privatized in Central Europe during the early 1990s, including 23,500 in the Czech Republic and 194,000 in Poland. Small-scale privatization in Poland (and indeed almost everywhere else in transition economies) was relatively non-contentious and has been judged a great success, in terms of improving the quality and quantity of services and goods provided and in creating many jobs for those shifting out of restructured or privatized SOEs.³⁷ In about 70% of these cases, the investor acquired the leasehold (land use rights). Transfers of building, land or equipment were much less common (Table IV-3).

**Table IV-3. Small Privatization in Central Europe:
Transfer of Assets**

	Frequency of Transfer		
	<u>Czech Republic</u>	<u>Poland</u>	<u>Hungary</u>
Leasehold	72%	69%	65%
Building	<u>28%</u>	<u>31%</u>	<u>35%</u>
	100%	100%	100%
Equipment	35%	40%	37%
Land	20%	15%	11%

Source: World Bank, *Eastern European Experience With Small-Scale Privatization*, p. 5.

An important lesson is that much time and effort might be saved by focusing on the key asset – real estate or business premises – rather than on privatizing going concerns or business activities. Encumbering the transfer of real estate with other assets and

³⁴ Florencio Lopez-de-Silanes, "Determinants of Privatization Prices," *Quarterly Journal of Economics*, volume 112, 1997.

³⁵ World Bank, *Selling State Companies to Strategic Investors*, pp. 3-6.

³⁶ World Bank, *The Case-by-Case Approach to Privatization*, p. 2.

³⁷ World Bank, *The World Bank, Privatization and Enterprise Reform in Transition Economies*, p. 8.

liabilities is clearly not the most efficient way to achieve this transfer. The Polish approach of directly freeing up real estate was a very effective and its feasibility in other country contexts merits consideration. Where for political reasons the sale of going concerns is unavoidable, pre-privatization valuation and sale should focus on the enterprise's real estate. There is little to be gained by more in-depth valuation of the business as a going concern. An important corollary to focusing on the real-estate asset is that efforts should be made to develop a secondary real-estate market for commercial space in order to ensure efficiency in the allocation of this scarce resource.³⁸

The conveyance of small enterprise real estate should encourage follow-on investment.

Experience from Central Europe indicates that outright sale of premises (land and/or building) provides the greatest security over tenure, facilitates secured financing, and encourages additional investment in the business. For the rapid development of an efficient market-oriented retail and services sector, there seem to be significant benefits in conveying full ownership of the real estate with as few restrictions as possible. If premises cannot be sold but are instead leased, leases should be of long duration – preferably over five years – and, if possible, should contain options to purchase or renew. The renewal process should be clearly defined from the start to reduce the degree of uncertainty for potential bidders.³⁹

Liquidation can be an efficient sales method for enterprises that are insolvent or difficult-to-audit. Liquidation involves the sale of enterprise assets and the use of asset sale proceeds to pay off enterprise debts; the buyer assumes none of the enterprise's debts and avoids exposure to hidden or contingent liabilities. This may be highly desired by the potential buyer of an insolvent enterprise or an enterprise (or enterprise group) with an overly-complex capital structure (e.g. cross-shareholdings, cross-guarantees on debt). Liquidation may be used to sell both small and medium/large SOEs. In Poland, liquidation permitted firms, without passing through a court insolvency procedure, to sell assets, lease out assets, enter into joint ventures, and merge with other firms. This became a principal method for providing former small SOEs and new start-up small businesses with the real estates and assets they desperately required.⁴⁰ Between end-1990 and end-1996, 3,373 of Poland's 8,441 medium/large enterprises (i.e., 40%) entered a liquidation or insolvency process (Table IV-4).

³⁸ World Bank, *Eastern European Experience With Small-Scale Privatization*, pp. 5-11.

³⁹ Ibid.

⁴⁰ World Bank, *The World Bank, Privatization and Enterprise Reform in Transition Economies*, p. 12.

Table IV-4. Poland's Ownership Transformation of Medium/Large SOEs, 1991-1996

	<i>Initial</i>	Completed		<i>Remaining</i>
Liquidation:				
<i>1990 Privatization Law</i>	1,247	1,221	98%	26
<i>SOE Law</i>	1,464	494	34%	970
<i>Bankruptcy Act</i>	<u>662</u>	<u>358</u>	<u>54%</u>	<u>304</u>
	3,373	2,073	61%	1,300
Other Ownership Transformation	5,068	1,898	37%	3,170
TOTAL	8,441	3,971	47%	4,470

Source: Adapted from Blaszczyk and Woodward, *Privatization and Company Restructuring in Poland*, 1999. Ownership transformations included 512 SOE transfers to National Investment Funds and 1,386 other privatizations.

This number exceeded the number of medium/large SOEs privatized by other means. For a nation with no practical experience in insolvency, the liquidation of medium/large SOEs proceeded relatively quickly. By end-1996, 61% of the liquidation cases had been completed. It appears that liquidations proceeded most rapidly under the special-purpose privatization law (98% completion rate) and most slowly under Poland's SOE law (34% completion). Further study of Poland's use of liquidation for ownership transformation and its potential applicability to China seems worthwhile.

Elaborate valuations of the “going concern” value of medium-sized SOEs are generally a waste of time. A book value approach, so long as it includes value of the real estate, will usually make the most sense. In theory, a proper valuation should include a discounted cash flow (DCF) analysis.⁴¹ Indeed, this is often needed for sales of large SOEs. DCF valuation may be impractical for medium-sized SOEs, however, especially in a transition economy. In Central Europe, the government or its advisors typically prepared two valuations: (i) a business valuation based on the enterprise's future cash flow; and (ii) an asset valuation of the enterprise's “book value.” Both valuation methods had their weaknesses:

- Business (i.e., DCF) valuations varied widely due to differing business assumptions between the buyer and the seller; uncertainties about future earnings, especially in a transitional economy; and the forecast time horizon.⁴² While it probably makes no sense to project cash flows more than five years into the future, the “terminal value” of subsequent cash flows can be substantial and assumptions about terminal value can significantly affect present value calculations as can choice of discount rate. In some cases in Central Europe, the high valuation for an SOE was 6 times the low valuation.
- Asset valuations suffered from two problems. First, SOE financial statements had to be adjusted (usually downward) to reflect differences between domestic accounting

⁴¹ World Bank, *The Case-by-Case Approach to Privatization*, pp. 22-4.

⁴² World Bank, *Selling State Companies to Strategic Investors*.

laws and international accounting standards, especially for such items as uncollectible receivables, obsolete inventory, unusable assets, and unrecorded liabilities. Second, valuation of land was a particular problem. Under socialist accounting, land received no value on SOE balance sheets: it was simply state property used by state enterprises. Because property markets functioned poorly, it was difficult to find market comparables to value SOE land. These problems notwithstanding, book value proved to be a reasonable guide to final sales price.⁴³

Government officials may feel a need to “correctly” value state assets prior to sale and to avoid selling state assets “below value.” Experience from Central Europe indicates, however, that business valuations are difficult to develop and use. Asset (book) valuations are easier to develop but may also suffer from methodological difficulties. Ultimately, the market value of an enterprise depends on two things: (1) the price a ready and willing seller agrees to accept; and (2) the price a ready and willing buyer agrees to pay.

Rather than focusing beforehand on enterprise “value,” sellers should initially focus on procedures to maximize the number of potential buyers and minimize their potential uncertainty. This is the most practical way to maximize sales proceeds.

OECD experience shows that open, transparent, and competitive processes generate better outcomes in terms of sales proceeds and quality of buyers. The gains in terms of better outcomes and program credibility generally outweigh the costs of running competitive processes.⁴⁴ In Mexico, for example, price was the main criteria in 98 percent of SOE sales. Maximizing the number of bidders in an open auction was usually the best way to maximize revenues.⁴⁵ Experience from Central Europe supports an emphasis on measures to increase competition and minimize uncertainty among potential buyers as a way to get the highest bid price, which can then be taken as the true “market value” of the enterprise.⁴⁶ Measures to achieve this include the following:

- **Information memorandum** – For each medium-sized SOE being offered for sale to outsiders, an information memorandum should be provided. This information memorandum should provide a clear description of the enterprise, including products or services, major customers, assets, workforce, current organization and management. If confidential or privileged information is provided, the potential buyer may be required to sign a confidentiality agreement and observe other controls on use of this information.
- **Financial statements** – Any serious potential buyer should want to see an enterprise’s recent income statements, balance sheets, and cash flow statements, preferably for the previous 3-5 years. These should be prepared according to international accounting standards (IAS). Especially in a transition economy, this may require adjustments such as for uncollectible receivables, obsolete inventory, fixed assets, and

⁴³ Ibid.

⁴⁴ OECD, p. 37.

⁴⁵ Lopez-de-Silanes, “Determinants of Privatization Prices”.

⁴⁶ World Bank, *Selling State Companies to Strategic Investors*, pp. 7-8.

unrecorded liabilities. If the potential buyer is foreign, the seller should be prepared to hire an international accounting firm to re-state the enterprise's financial statements according to IAS. The enterprise's financial statements should have been independently audited, preferably according to international audit standards.

- Due diligence – Serious potential buyers should have a reasonable opportunity to conduct “due diligence” on the enterprise by reviewing detailed commercial, financial, technical, legal, and environmental data. Sometimes, these are assembled in a “data room” which qualified potential buyers can access through appointment.
- Draft sale/purchase agreement – Giving potential buyers a draft sale/purchase agreement, which can be subject to further negotiation, is a useful way to clarify the structure of the proposed transaction as well as potential issues and assurances.
- Certainty of title and liabilities – Buyers want to know they are getting clear title to the enterprise's shares or assets and (in a “going concern” sale) that they are not assuming any hidden liabilities. They may be willing to pay extra for this “peace of mind.” Thus, sellers may find it useful and rewarding to include the following in the draft sale/purchase agreement: a warranty that the enterprise's shares or assets are free of any liens or encumbrances (e.g., from the tax authorities, suppliers); a similar warranty that there are no hidden liabilities; indemnification of the buyer against any undisclosed liens, encumbrances, or liabilities; and precise identification of any environmental liabilities that the buyer is expected to assume. Identification of these items and their inclusion in the draft sale/purchase agreement reduces the opportunity for last-minute negotiations over sales price.⁴⁷
- Advertising – Information on SOE purchase opportunities should be disseminated as broadly as possible through (as appropriate) international, national, or local press and perhaps through the internet. Interested parties should be informed how to obtain additional information.
- Qualification of potential buyers – To filter out non-serious parties, it is reasonable to ask potential buyers to make a deposit in order and sign a confidentiality agreement in order to obtain a copy of the information memorandum, draft sale/purchase agreement, and an opportunity to do follow-on due diligence. The deposit, which may be fully or partially refundable upon final sale, should not be so large as to discourage potential qualified buyers.

5. Sales method

The most basic choice is whether the sales process should be “open” or a “closed.” Experience shows that an open sales process tends to maximize sales proceeds, post-sale investment, and political credibility. A closed process – involving, for example, only insiders or a strictly limited number of potential buyers – is cheaper and easier to organize and offer greater flexibility than a competition among a larger number of potential buyers. A possible lack of transparency, however, may leave a closed process vulnerable to charges of favoritism or corruption. OECD experience shows that an open

⁴⁷ Ibid.

competition among potential buyers encourages higher sales proceeds and higher-quality buyers, and that open processes receive greater public support.⁴⁸

In the transition economies of Central Europe, small SOEs have often been sold by public auction, with sales price as the only criterion. Sales methods for medium/large SOEs are more varied and may include the following:

- “Trade sale” to a dominant strategic or financial investor;
- Initial public offering (IPO);
- Management buy-out (MBO) or management/employee buyout (MEBO); or
- Mixed sale, involving two or more of the above choices.

These sales methods, which are further described below, vary in their tendency toward being open or closed. By its nature, an initial public offering is a public, price-based process open to individual and institutional investors. A trade sale may be based on price or price plus other conditions (e.g., proposed business plan, follow-on investment, employment guarantees). The trade sale may proceed through an open auction or open tender in which any qualified potential buyer may compete, through a closed tender to a limited number of pre-selected potential buyers, or through direct negotiations with a single potential buyer.

If at all possible, small SOEs should be sold through public auction for the highest price. Choice of method varied among Central European countries: the Czech Republic relied on public auctions; Poland often used closed procedures where prices did not necessarily reflect market values; and Hungary used a mix of auctions and directly-negotiated rents. The key issue in choosing a method for sale of small SOEs is whether the benefits of open auctions/tenders (i.e., efficiency, fairness, transparency) outweigh the potential advantages of insider support inherent in closed procedures? Survey results from Central Europe indicate that investment (post-privatization) in small SOEs transferred through open procedures was significantly higher than in small SOEs transferred through closed procedures. Open procedures were much more likely to result in outsiders taking over the business. There were clear benefits in involving outsiders in the privatization of small SOEs in Central Europe.⁴⁹

For medium/large SOEs, trade sales may be most useful for maximizing sales proceeds or for attracting a strong management and new technology. Trade sales have been a highly popular method for selling medium/large SOEs in Hungary and Mexico (see Table 4) as well as Poland. All other factors being equal, sales proceeds will likely be higher than if the government chooses to sell through a public offering.⁵⁰ This is because the buyer typically acquires control over the enterprise in a trade sale and is willing to pay more (i.e., a “control premium”) to acquire this control. The control premium may increase sales proceeds 20 percent or more over what might be expected from a public offering.⁵¹ Other expected advantages include possible foreign investment and

⁴⁸ OECD, pp. 53-4.

⁴⁹ World Bank, *Eastern European Experience With Small-Scale Privatization*, p. 9.

⁵⁰ World Bank, *The Case-by-Case Approach to Privatization*, p. 22.

⁵¹ Bai, p.7.

technology, stronger governance by a dominant shareholder. Since a dominant shareholder is involved, a trade sale generally places fewer demands on a nation's legal/market infrastructure. If minority shareholders remain, however, strong protections are needed to deter the dominant shareholder from expropriation of minority shareholders. On the other hand, trade sales do nothing to develop capital markets. A closed process may leave a trade sale vulnerable to charges of corruption or favoritism. In Poland, however, a set of clear, detailed, and transparent processes has allowed trade sales to be successful and effective.⁵²

Trade sales can be time-consuming, but measures can be taken to expedite the process.

Trade sales have been used most heavily in Mexico and Hungary (Table IV-5). A trade sale may be less time-consuming than an IPO, especially if the IPO requires more pre-sale restructuring. However, trade sales can also take a lot of time. A survey of Central European trade sales showed, for example, that 15 months of elapsed time and 30+ person months of advisors' time was needed on average to prepare/negotiate each transaction.⁵³ In non-transition OECD countries, trade sales have also been time-consuming. In the U.K., for example, the Thatcher government's enthusiastic and dedicated privatization team managed to sell about 20 companies over a 10-year period. In Mexico, which started off with a larger number of much smaller firms, the government managed to sell about 150 SOEs in six years.⁵⁴ Delays in concluding trade sales may lead to business/financial deterioration of the enterprise or asset stripping. These realities led several governments in Central/Eastern Europe to decide, largely for political reasons, to use "voucher" auctions to privatize thousands of medium/large SOEs within 18-24 month periods. In cases where voucher sales are unacceptable, other means to expedite trade sales include the following: ongoing negotiations with more than one potential buyer; potential recourse to alternative sales methods (e.g., IPO, MBO); and up-front clarity on potentially sensitive issues (e.g., liens, environmental or hidden liabilities, warranties, indemnities) as discussed earlier.

Table IV-5. Medium/Large Privatization Transactions, by Method, 1980-2001

<u>Country</u>	<u>Method</u>		
	<u>Public offering</u>	<u>Trade sale</u>	<u>Other</u>
Australia	36%	46%	18%
France	57%	7%	36%
Hungary (1)	16%	81%	3%
Mexico	19%	74%	7%
Portugal	60%	40%	-
Spain	91%	9%	-

Source: OECD, pp. 55-6
(1) 1995-2001.

⁵² OECD, p. 53.

⁵³ World Bank, *Selling State Companies to Strategic Investors*, p. 11.

⁵⁴ World Bank, *The World Bank, Privatization and Enterprise Reform in Transition Economies*, p. 8.

The main benefit of public offerings is to promote capital market development and discipline. Otherwise, IPOs place heavy demands on local institutions. Mostly suitable for large and well-known SOEs, IPOs serve to increase the supply of shares in public markets and may subject the issuing enterprise to greater market scrutiny and discipline, especially in an environment characterized by adequate disclosure and corporate governance. IPOs are generally the most transparent method of sale. But sales proceeds are usually lower from IPOs, since the likely wide dispersion of shareholdings precludes the possibility of a control premium. Moreover, IPOs require lots of preparation and use of advisors (see Box IV-4) and, hence, are the most expensive type of sale to organize. For both the IPO and post-offer trading to be successful, the country should have a relatively well-developed financial and legal system, including adequate stock market infrastructure and liquidity; adequate laws on companies, property rights, securities, and insolvency; and adequate market surveillance and enforcement by the securities regulator. Given the tendency of IPOs to disperse share ownership, it is especially important that strong corporate governance and securities market surveillance/enforcement mechanisms be in place to protect minority outside shareholders. On the other hand, IPOs for large enterprises can provide an impetus for necessary development of the financial and legal system.

Box IV-4. Typical Steps in an Initial Public Offering (IPO)

In addition to any pre-sale restructuring, accounting/auditing, and valuation work, an IPO will typically also involve the following preparatory steps:

- Retention of financial advisors, sales agents (brokers or underwriters), lead brokers, and placement syndicate members.
- Drafting of the prospectus, which is done by the financial advisors or sales agents in cooperation with SOE managers and government officials. The prospectus must address dividend policy; environmental issues; relevant regulations; employee and management participation in the share issue; management of any residual government shareholdings; and government intentions toward the enterprise and the industry.
- Selecting shares and related instruments – e.g, common or preference shares, convertible bonds, warrants.
- Resolving basic issues in organization of the IPO – e.g., maximizing price vs. facilitating sales; broad distribution vs. focus on institutional investors; possible use of global or American depository receipts (GDRs/ADRs); procedures to finalize pricing of the issue.
- Implementing the public sales campaign, including the organization of “road shows” (possibly including key international securities markets) to showcase the company and the share issue;
- Determining issue pricing (retail and institutional) and distribution (domestic and foreign), with government approval.

World Bank, March 1998, pp. 12-3.

Management/employee buyouts (MEBOs) may be warranted in special circumstances. But given potential drawbacks (e.g., lack of transparency, insider dominance), MEBOs should not be adopted as the standard sales method simply for reasons of expediency. MBOs/MEBOs can certainly be the easiest method for eliciting support from workers and management. This technique can also be relatively simple and fast, especially when installment purchases are allowed or encouraged. MEBOs were the primary privatization method in Slovenia, Croatia, Macedonia, Romania, Uzbekistan, Ukraine, Azerbaijan, Albania, Turkmenistan, and Belarus and a secondary method in Poland, Kyrgyzstan, and Armenia.⁵⁵ Only 2 or 3 of these countries are now considered to have experienced success in their privatization programs and in the post-privatization restructuring and performance of former SOEs. MBOs/MEBOs may be appropriate for smaller enterprises that depend highly on the scientific/technical skills and judgment of its employees.⁵⁶ The typically closed nature of MBOs/MEBOs, however, leaves the participants open to potential public criticism for favoritism and corruption. Evidence from socialist and non-socialist countries indicates that workers tend to use their powers as owners or managers to protect their jobs or increase their wages rather than to enhance competitiveness. There is little evidence that this sales method is associated with extensive post-sale restructuring. Sale to a concentrated management group is preferable to widely-dispersed ownership. But the empirical record shows that sale to outsiders results in greater post-sale restructuring and enterprise productivity and profitability than does sale to insiders.⁵⁷ Experience from OECD countries indicates that there has been less restructuring when the shares have been obtained for free.⁵⁸ If sales are transferred to managers/employees, it appears that these insiders should pay some market-based price instead of getting their shares for free.

Mixed sales can be a useful way to combine the attractive features of alternative sales methods. Mixed sales were often used successfully in Central Europe. For example, a trade sale to a dominant shareholder may be combined with an IPO and/or with a small sale to employees. In the case of a trade sale/IPO, for example, this could combine the higher sales proceeds and dedicated outside management team benefits of a trade sale with opportunities for the public to share in the resulting benefits. Especially in the cases of a combined trade sale/IPO, it will be critically important for good financial disclosure, good corporate governance practices, and good market surveillance/enforcement mechanisms to be in place to protect public shareholders from dominant inside shareholders.

Key considerations, advantages, and disadvantages of these main sales methods are summarized in Table IV-6.

⁵⁵ Ibid, p. 24.

⁵⁶ OECD, p. 58.

⁵⁷ World Bank (Nellis, 2002), p. 10 citing Hinds.

⁵⁸ OECD, p. 58.

Table IV-6. Key Features of Main SOE Sales Alternatives

Alternative	Advantages	Disadvantages	Main Applicability
<u>Process:</u> Open	<ul style="list-style-type: none"> • More competition • Higher-quality buyers • Larger sales proceeds • Better for enterprises • Transparency • Public support 	<ul style="list-style-type: none"> • Additional expense • Additional time 	<ul style="list-style-type: none"> • Strong government owner/seller
Closed	<ul style="list-style-type: none"> • Low cost • Flexibility • Speed 	<ul style="list-style-type: none"> • Lower-quality buyers • Non-transparent • Opportunities for corruption • Public criticism 	<ul style="list-style-type: none"> • Overwhelming insider dominance
<u>Buyer:</u> Trade sale	<ul style="list-style-type: none"> • Higher sales proceeds (“ control premium”) • Strong management • Possible foreign investment/technology • Fewer demands on legal/market infrastructure 	<ul style="list-style-type: none"> • Time consuming • No support for capital market development 	<ul style="list-style-type: none"> • Great majority of medium/large SOEs
IPO	<ul style="list-style-type: none"> • Develops capital markets • Possible market supervision of enterprise • Highly transparent 	<ul style="list-style-type: none"> • Lower sales proceeds • Extensive preparations • High costs • Time consuming • High demands on legal/market infrastructure 	<ul style="list-style-type: none"> • Large, well-known, & well-run SOEs • Strong legal/regulatory protections for minority shareholders in place
MBO/MEBO	<ul style="list-style-type: none"> • Speed • Support from management/workers 	<ul style="list-style-type: none"> • Non-transparent • Possible favoritism or corruption • Public criticism • Unlikely to help competitiveness 	<ul style="list-style-type: none"> • Small SOEs dependent on scientific/technical skills of staff
Mixed sales	<ul style="list-style-type: none"> • Somewhat higher sales proceeds • Strong management • Opportunity for public to share in gains • Public support • Develop capital markets 	<ul style="list-style-type: none"> • More complex transaction • High costs • Time consuming • High demands on legal/market infrastructure 	<ul style="list-style-type: none"> • Medium/large SOEs likely to attract strategic (e.g., foreign) investors

6. Post-Sale

Final issues for consideration in development of an SOE sales program include possible post-sale conditions or restrictions, environmental issues, residual government ownership, use of “golden shares,” purchase financing, and supporting policies.

Post-sale restrictions on the buyer should be avoided or minimized. SOE sale/purchase agreements in Central Europe sometimes included post-sale restrictions, such as on re-sale of the enterprise, line of business, or worker layoffs. Experience indicates that such restrictions should be avoided if at all possible. Restrictions on enterprise re-sale or premises sub-letting severely impede the development of secondary markets and prolong original inefficiencies, for example in access to real estate. For the rapid development of an efficient market-oriented retail and service sector, there are significant benefits in conveying full title to real estate and with as few restrictions as possible.⁵⁹ Restrictions on post-sale employee layoffs may also be misguided.⁶⁰

Post-sale commitments by the buyer, which may be difficult to monitor and enforce, should be minimized. A higher sales price is preferable to post-sale commitments. Post-sale buyer commitments – which can cover such matters as future capital investment, labor retention, service levels, and environmental cleanup – have been used in many countries, e.g., Czech Republic, Poland, Germany, Hungary, Korea, Mexico, and Turkey. Experience from OECD suggests, however, that such post-sale commitments can be difficult and costly to monitor and enforce, while tending to prolong government involvement. In Hungary, for instance, the Apvrt state holding company was faced in 2000 with monitoring over 22,000 contracts and managing over 650 lawsuits with investors.⁶¹ Post-sale buyer commitments often result in sales price reductions which, in combination with the cost of monitoring sale/purchase contracts, further reduces net sales proceeds to the government.

The government should develop transparent and predictable regulations and incentives to reduce the risk and cost associated with environmental problems. In case of the proposed sale of an SOE that causes damaging pollution, the seller will need to address environmental issues in order to reduce uncertainty for both the buyer and the government. Typically, the enterprise is responsible for mitigating new pollution. Thus, the main issue has to do with how to handle existing environmental damage (e.g., to subsoil or groundwater). Failure to address such environmental issues has delayed and even derailed many privatization transactions. In most cases, this means that the government will have to assume some environmental risks and indemnify the buyer from unknown risks. Approaches that have been used include allowing buyers to set aside part of the purchase price to pay for environmental clean-up (Czech Republic, Poland), indemnifying buyers for costs incurred during clean-up (Bulgaria, Germany), and lowering the purchase price but making the buyer responsible for cleanup (Argentina).

⁵⁹ World Bank (Frydman), 1994, p. 7.

⁶⁰ Of course it is important to distinguish between a buyer's guarantee of a certain number of jobs and a guarantee to keep existing employees on the job. The former might be less problematic.

⁶¹ OECD, p. 57.

Investors in OECD countries and Eastern Europe try to control their financial exposure when buying environmentally-problematic enterprises. Measures include:

- Environmental audits, to help identify an enterprise's environmental liabilities and reduce valuation uncertainty;
- Remedial actions, depending on the health risks caused by existing environmental damage;
- Pre-closing conditions (e.g., a requirement for the seller to release a buyer from the sale/purchase agreement if an environmental audit identifies too-serious problems);
- Indemnification for costs incurred fixing specified problems;
- Warranties for problems discovered only after transfer of ownership; and
- Private insurance.⁶²

Residual government shareholdings can be a disincentive, especially in a trade sale.

Governments sometimes seek to retain some shares, for example, to fund environmental or restitution claims or to provide some benefit to local governments. Trade investors, however, usually want to maximize control and minimize involvement with minority shareholders. Experience from trade sales in Central Europe suggests that, if requested, government sellers should be prepared to sell 100 percent of an SOE's shares to a buyer and give the buyer the option of making any necessary payments (e.g., for environmental cleanup, for local governments) in cash.⁶³

Arrangements to allow the government to retain special powers through a "golden share" should be used infrequently, if at all. If golden shares are used, their powers should be narrowly-defined, time-limited, and invoked under strictly-defined circumstances.

Golden shares give governments special post-sale powers to approve or veto major initiatives, such as the sale of majority shares to a third party, sale of major assets, liquidation, or reorganization. First introduced in the U.K. to prevent newly privatized enterprises from being taken over, golden shares have been used in many additional OECD countries: e.g., France, Netherlands, Spain, Portugal, Belgium, New Zealand ("Kiwi shares"), Italy, Czech Republic, Poland, Hungary, and Turkey. Golden shares have not been used or permitted in Mexico, Sweden, Switzerland, Australia, and Germany. Golden shares may facilitate undue government interference or undermine the market for corporate control.⁶⁴ By increasing uncertainty or restraining the enterprise's post-sale commercial freedom of action, golden shares may diminish the enterprise's value and sales price.⁶⁵ OECD experience suggests that potential drawbacks from golden shares can be mitigated by narrowly focusing the scope of golden share powers, by making those powers time-limited (e.g., to 3 years after sale), and by specifying circumstances under which special powers may be invoked (Box IV-6).

⁶² World Bank (Welch), 1998, p. 7.

⁶³ World Bank (Rutledge), 1995, p.3.

⁶⁴ OECD, p. 64-5. For example, the existence of golden shares has deterred the takeover of KPN (a partially-privatized Dutch telecommunications company) and Spain's Telefonica.

⁶⁵ World Bank (Welch), 1998, p. 17.

Box IV-6. Use of Golden Shares: Selected Cases

U.K.: While varying among industries, golden share powers have tended to be time-limited. A typical prohibition has been on one person or group acting together to control more than 15% of a company's equity. For defense industries, golden shares have no time limit and additional powers are included, e.g., nomination of directors, disposal of major assets. As a matter of policy, the retention of a golden share has been treated as an exceptional matter, one that does not allow government interference in the business affairs of the company. Over the years, the government has been relinquishing its golden shares in most sectors, except for defense. In the case of British Telecom, the government relinquished its golden share to dispel investor uncertainty during merger discussions with MCI. Except in defense industries, golden share powers have never been invoked.

France: Golden shares ("action spécifique") were introduced in 1986. There is now no time limit, but the government may elect to convert golden shares into regular shares. Typically, golden shares give government powers to require authorization from the Ministry of Economy and Finance for any concentration of control above a certain percentage; to appoint two non-voting directors to the board; and to block the sale of any assets (e.g. shares, real estate, intellectual property) to protect national interests.

Italy: A 1994 law provided broad powers to protect public order, safety, health, and defense. Golden share powers were more narrowly specified in 1999, in part due to European Union action and to a hostile takeover bid for Telecom Italia and its proposed defensive merger with Deutsche Telekom. Since then, golden share powers could be invoked only under specified conditions: e.g., non-transparency in the ownership of privatized shares, over-riding public interest, proportionality, and non-discrimination.

Portugal: Golden share powers have limited participation by non-nationals in insurance, banking, transport, and energy.

Poland: The government used golden shares in some privatized companies to ensure control and supervision of post-sale commitments by the buyer.

OECD, pp. 64-5 and 84-5.

Lack of financial resources will likely constrain many domestic buyers. But special programs to provide bank financing of SOE purchases – except for small SOEs – are fraught with hazard. Government sellers may be driven to accept purchase financing through installment payments, which also need to be carefully monitored. Especially if the new owner of a small SOE will own the premises or can give the lease as collateral, bank financing of purchases of small SOEs seems a reasonable credit risk. Experience from Central Europe, however, raises more questions about bank financing of the purchase of medium/large SOEs. In the Czech Republic, for example, there were a number of well-known cases where local investors purchased "crown jewel" SOEs for inflated book values, financed these purchases with loans from state-owned banks, obtained additional loans after privatization, and siphoned funds from the enterprise over an extended period of time. The dangers of asset stripping and "tunneling" are especially

great if enterprise ownership is widely dispersed and banks are state-owned.⁶⁶ Imprudent lending for the purchase of SOEs can lead to distress both for the enterprise and for the financial institution creditor. The installment payments alternative for financing the purchase of SOEs was frequently used in Central Europe. Typical terms varied from country to country. For example, in Estonia domestic purchasers were expected to make a 20% down-payment and pay off the 80% balance in installments over 3-10 years. In Slovakia, buyers were expected to put 10% down and pay off the 90% balance in installments over 2-7 years.⁶⁷ Problems arise when buyers fail to make installment payments, for example, because actual company cash flows fall short of projections or because buyers exploit weak legal protections for creditors. In Estonia, for example, almost 20% of buyers had difficulty in meeting their installment payment schedule as of end-1995.⁶⁸ Delinquent installments create a dilemma for governments, which presumably do not want to re-nationalize former SOEs. In such cases, it may make particular sense for the government to sell the outstanding installment balance to a private investor or fund and allow it to collect or take over the delinquent enterprise. More generally, it may make sense for the government seller to sell any installment balances for cash or to retain private vendors to monitor and pursue collection of installment balances.⁶⁹

For former SOEs to develop successfully under non-state ownership, the sales program must be complemented by appropriate policies in other areas. These include a wide range of macroeconomic policies, deregulation of the tradables sector, and other structural reforms. Poland's transition model, for example, succeeded without mass or rapid privatization because of a complete liberalization of new business entry; abolition of the power of workers' councils; liberalization of about 90% of prices; stabilization through tight fiscal, monetary, and wage policies; hard budget constraints on SOEs; and near-complete trade liberalization and current account convertibility. The introduction of free trade and free entry for start-up businesses, combined with a tightened budget constraint on most remaining SOEs, and the introduction of mechanisms for spinning-off productive assets from SOEs without formally privatizing them, presented a viable alternative to mass and rapid divestiture. In conjunction with quick sale of 194,000 small SOEs, these policies encouraged the growth of *de novo* private firms, which turn out to be the principal engine of recovery and growth in transition economies. One cannot borrow a single part of an integrated policy package applied elsewhere and expect it to replicate the full range of effects achieved in the original instance. "Evolutionary and cautious large-scale privatization worked in Poland because it was enmeshed in a setting of sound and well-applied economic and financial policies, vibrant new entry, robust

⁶⁶ For a somewhat theoretical treatment, see World Bank, *Ownership Structure and the Temptation to Loot: Evidence from Privatized Firms in the Czech Republic*, (Cull), 2001. The authors usefully distinguish between one-time asset stripping and bank-financed "tunneling" of enterprise assets over an extended period.

⁶⁷ World Bank, *The Restructuring of Large Firms in Slovakia*, (Djankov/Pohl), 1997, p. 12.

⁶⁸ World Bank, "Finding Real Owners – Lessons from Estonia's Privatization Program" (Nellis), *Viewpoint*, No. 66, January 1996; and World Bank.

⁶⁹ Such arrangements would be similar to operations at the Indonesia Bank Restructuring Agency (IBRA), which sold small loans by auction and hired commercial agents to collect on mid-sized loans of \$0.5 to \$5.0 million.

political competition, and the rudiments of corporate governance in remaining SOEs provided (certainly) by the workers' councils on the one hand, and (perhaps) by the professional and private NIF managers on the other hand.”⁷⁰

Protection of private property rights is also essential. This can seem an especially nettlesome goal in cases where companies have been sold under less-than-impeccably-transparent circumstances. Notable examples from Central/Eastern Europe include enterprise sales to government favorites after 1992 and Russia's infamous “loans for shares program” in the mid-1990s.⁷¹ Years later, these transfers elicit sharp public criticism. Despite changes in government, successive governments have refrained from un-doing these controversial transactions. The official reasoning has been that the negative effects on the perceived sanctity of private property would outweigh the positive benefits from re-distributing former state property through a more transparent process.

C. Implications for China

The most basic issue is whether China should follow an “open” or “closed” approach to SOE ownership transformation. Over the past decade, except for 1000 or so initial public offerings (IPOs) and foreign-invested joint ventures, ownership transformation has largely proceed through the closed process of management buy-outs (MBOs) or management-employee buy-outs (MEBOs). Apart from offering greater speed and flexibility, closed processes may forestall political debates on the merits of ownership transformation. But worldwide experience conclusively demonstrates the great advantages – both to the State shareholder/seller and individual enterprises – from an open process. It is useful to think about ownership transformation in terms of discrete stages: (a) goals and policies; (b) institutional framework; (c) preparations for sale; (d) conduct of sale; and (e) after-sale:

(a) The goals of ownership transformation should be to maximize sales proceeds and to create the most favorable possible conditions for the future development of former SOEs. Outsiders should have an equal opportunity to compete with insiders to purchase enterprises. It is clear from international experience that outside owners are likely to be more effective in post-sale restructuring and in improving enterprise productivity and profitability. The ownership transformation process should be as open as possible, for example, through an emphasis on open auctions or open tenders. Open processes are needed to encourage bids from outsiders (who are likely to be more-qualified buyers), to maximize sales proceeds, and to provide needed transparency.

(b) Transparency and centralized decision-making are essential. Transparency is needed to maintain public support for ownership transformation and to forestall future allegations of corruption. Necessary transparency results from publication of clear and comprehensive rules and procedures to govern enterprise sales; publicity on upcoming sales; dissemination of reliable information on enterprises; a competitive sales process (e.g., public auction, tender, or share offering); equal treatment of domestic and foreign

⁷⁰ World Bank (Nellis), 2002, pp. 16-8.

⁷¹ Lieberman and Viemetra, p. .

investors; rules on real or potential conflicts of interest; publication of enterprise sales results; and oversight by an appropriate public entity. At least for large or complex sales, use of an outside financial advisor would enhance transparency and sale results. SASACs should have wide discretion to organize and conclude ownership transformations, subject to higher-level approval only for particularly large or important transactions.

(c) The pre-sale restructuring of SOEs should be minimized. Elaborate calculations of the “going concern” value of medium-sized SOEs are a waste of time and effort. A book value valuation, so long as it includes the value of any real estate (e.g., land use rights), is an adequate reference point for auctions or tender negotiations. An SOE is worth only what a ready and willing buyer will pay for it. Thus, rather than focusing beforehand on calculations of “enterprise value,” SASACs should instead focus on procedures (e.g., bidder access to enterprise information, warranties or indemnifications to manage risks to the buyer, advertising) to maximize competition among potential buyers and minimize their potential uncertainty. This is the most practical approach to maximizing sales proceeds and attracting the most qualified buyers.

(d) The sales method used in each ownership transformation should suit the characteristics and needs of each particular SOE:

- The *sale of small SOEs* and their valuation should focus on the transfer of real estate or access to real estate (e.g., land use rights, leaseholds). Adding other assets (e.g., inventory, fixtures) and liabilities (e.g., debt) to the transaction needlessly complicates the sale of small SOEs. If at all possible, small SOEs should be sold simply for the highest price through a public auction. From our analysis, it is clear that small/medium SOEs do not belong in China’s SOE portfolio. Small/medium SOEs tend to be perpetual loss-makers; to diminish rather than enhance State capital; and to pose greater liability risks. Full and rapid implementation of the 1999 4th Plenum Decision to “let go” small and medium SOEs and “grasp” the large makes more sense than ever. This, however, will precipitate a huge number of transactions. Hence, an efficient sales program for small/medium SOEs will be especially important.
- *Liquidation* of small SOEs as well as medium-sized SOEs that are insolvent or difficult-to-audit, through an asset sale and separate settlement of claims, can be an extremely efficient method for ownership transformation.
- For the great majority of medium/large SOEs, a “*trade sale*” to a dominant shareholder (e.g., strategic investor) should be the preferred method for ownership transformation.
- Except in a few select cases, *initial public offerings (IPOs)* will not be worth the additional time, effort, expense, and risk to public shareholders. The use of IPOs should be limited to large, well-known, and well-run SOEs, whose public offering would contribute to capital market development and where protections for minority shareholders are adequate.
- Closed processes such as *MBOs/MEBOs* should be avoided, except perhaps in the case of small SOEs that are particularly dependent on the scientific/technical skills of

enterprise staff. If an MBO/MEBO is used, insiders should be required to pay something for their shares – albeit perhaps at some discount to market value.

- *Mixed sales*, such as a trade sale plus an IPO, are a good way to combine the best features of different methods. For practical reasons (e.g., cost, complexity), however, mixed sales should be limited to medium/large SOEs able to attract strategic (e.g., foreign) investors.

(e) Appropriate post-sale conditions are essential to accomplish the main goals of maximizing sales proceeds and promoting future development of former SOEs:

- *Post-sale restrictions* on the SOE or SOE buyer (e.g., on line of business, enterprise re-sale, worker layoffs) should be avoided, since these are unlikely to achieve any lasting effect – other than reducing sales proceeds.
- Similarly, *post-sale commitments* by the buyer (e.g., on capital investment, technology transfer) can be difficult and expensive for the State seller to monitor and enforce. A higher sales price is preferable to equivalent post-sale commitments by the buyer.
- Government regulations and incentives to deal with SOE *environmental damage* should be clear and predictable.
- SASACs should not insist on retaining residual shares, especially in the case of a trade sale.
- “*Golden shares*” – which may convey special powers to approve or veto such major initiatives as enterprise re-sale to a third party, sale of major assets, liquidation, or reorganization – should be used as infrequently as possible. Any golden share powers should be narrowly-defined, time-limited, and usable only under clearly-specified circumstances.
- Because a lack of wealth or access to financing will constrain many domestic buyers, at least for medium-sized SOEs, SASACs will continue to need to be prepared to agree to purchase financing through *installment payments*. Installment payments, however, should be carefully monitored. In cases where buyers fall behind on installment payments, it may make sense for SASACs to “outsource” resolution of the problem by selling delinquent balances to private investors or hiring commercial collection agents.
- The successful post-sale development of former SOEs will require *complementary policies* in a wide range of areas, including the liberalization of new business entry, macroeconomic stabilization, trade liberalization, creditor rights, banking reform, and business law reform.
- In the case of sale of a public utility, an appropriate regulatory framework will be of critical importance.
- Finally, the clarification and protection of *private property rights* is essential. Past ownership transformations – even those resulting from questionable, non-transparent processes – should be respected. No enterprise owner should ever be divested or driven out of business – including for environmental, health, or safety reasons – by the government without “due process” according to clear and well-established rules, standards, and procedures.

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