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# APPLICATION OF PRIVATE EQUITY IN CHINA STATE-OWNED ENTERPRISE REFORM By case study of Greenland Group

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FINANCIAL STRATEGIES AND CAPITAL MARKET

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## Summary

The purpose of this paper is to research the meaning of the fourth round of China state-owned enterprises reform and the effects of involving private equity participating into the reform process. A typical state-owned real estate enterprise Greenland Group has been chosen as the simple of the case study because its reform includes two main contents (mixed-ownership and overall listing) of the current round SOE reform. In-depth interviews were conducted with high relevant officers from Greenland Group and Shanghai State-owned Assets Supervision and Administration Commission. This paper focuses on researching the purpose of the current round of SOE reform and the impacts of private equity participating into the reform. This round of SOE reform is a necessary action for China's economy transition, it would improve state enterprises' corporate governance, optimize SOEs' shareholding structure, release enterprises' vitality and competitiveness by reducing government's administration interference on corporate operation. For Greenland Group, the mixed-ownership reform would break up the old order in management and improve corporate's marketization process, so that make corporate decision making become more scientific, independent and flexible. Meanwhile, implementing the reverse merger transaction is a triple-win for the government, PE firms and Greenland employee shareholding committee, that they would enjoy approximately six to seven times market value appreciation. The reasons for involving private equity firms rather than other investment institutions are that PE is more competitive in giving strategic

advice since private firms generally have more professional manager teams with rich and professional capital and corporate operation experience. Private equity would contribute to helping conservative state enterprises build modern corporate system, diversifying and monitoring the board of directors, improving corporate management incentive and salary systems, and providing SOEs value-added service based on their global vision and resources. At last, the author pointed out there was no foreign investment institutions won the bids for becoming major shareholders in state enterprises, so are there any provisions about prohibiting foreign capital joining in SOEs? The government claims that there is no prohibition or discrimination on foreign capital participating into China SOE reform. However, the reality reveals another view, it seems that the government determines to complete this reform process without foreign capital and let domestic investors take the biggest piece of cake intentionally, even at a lower price. In Sinopec's case, the oil retail unit was sold to domestic investment institutions at 20% lower price than the expectation price. This paper is one of the very few studies that researches about the current round China SOE reform and integrates private equity's impacts on the reform procedure.

<Inside Cover>

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## CHAPTER 1 INTRODUCTION

China has over 150,000 state-owned enterprises controlled by central and local government, and a majority of SOEs distributed in pillar industries, which have economical or political priorities such as oil, electricity and transportation. China has implemented three rounds of state-owned enterprise reforms during the transition process from planned economy to market economy, and SOEs are keeping update their operational mechanism to modern corporate system step by step through reform procedure. So far, there are still some noticeable problems existing in state enterprises such as mismanagement, inefficient, and less profitability compared with non-state enterprises—a 5% profitability gap existing between SOEs and private companies. Meanwhile, the government published the *China Manufacturing 2025*, it is a Chinese version “Industry 4.0” action plan, and “Internet Plus” strategy, which is integrating internet technologies with manufacturing and business, is also pursuing as a new strategy by the government aiming to make China update from “big industrial contrary” to “powerful industrial contrary” ([www.usito.org/news](http://www.usito.org/news), 2015). Thus, China is in an economy transition period right now, and it is necessary to promote another round of SOE reform to resolve the existing problems and improve SOEs corporate governance to adapt the more competitive market in the future.

The current round of SOE reform focuses on accelerating state assets exiting from SOEs, promoting SOEs’ mixed-ownership shareholding structure, improving corporate governance and overall listing on stock market. More importantly, a noticeable characteristic in this round of reform is involving private equity participating into the reform process, which is a new attempt for China’s government. Academic papers mostly made research on previously China SOE reform, while very few focus on the current reform that started from 2014, let alone integrating PE’s impacts on the reform, thus this is the reason that the author made this research.

Scholars such as Mok and Chau’s(2003) claim partial privatized enterprises have more efficiency

than solely state enterprises, then whether mixed-ownership reform would generate same effects on SOEs? Prior researches choose variables such as profitability and debt ratio to examine the impacts of partial privatization on corporates, however, besides of these quantifiable figures, what kinds of other influences that mixed-ownership can bring to state enterprises? Private equity has been confirmed can increase corporate's performance by Jensen(1989), Kaplan(1989) and many other researchers, while how and whether PE firms can benefit reforming SOEs is still a problem because of SOEs' complex shareholding structure. Qiao(2007) cites that introducing foreign private equity firms would broader financing channels and encourage implementing advanced corporate governance theories and help state enterprises overall listing in stock markets. Therefore, what is the government's attitude on involving foreign capital participating the reform? Are they welcomed or prohibited? This is a reform that just began and has many innovations compared with previous reforms, thus in this paper the above questions will be researched.

Greenland Group is chose as a case study here because it is a famous typical SOE which has diversified business expended overseas, meanwhile, it implemented both mixed-ownership reform and reverse merger during the reform, therefore, this Group is a perfect simple to study the research questions. In order to have a comprehensive understanding of the reform and PE's effects on corporate governance, the author interviewed high relevant officers from both Greenland Group and Shanghai State-owned Assets Supervision and Administration Commission.

In this paper, the perspectives of promoting SOE reform are illustrated from both the enterprise's side and government's side. The government hopes will improve state assets liquidity that exiting from SOE smoothly, and reduce administration interferences on state enterprises generally, leave enterprises making decisions indecently and be responsible to their profits and losses rather than relying on governments subsidies and monopoly market shares. The government expects this reform will improve SOEs become more marketable, professional and competitive. Meanwhile, on SOE's side, this reform is supposed to diversify shareholding structure, breaks up the old order in

management making their operational decisions more scientific, independent and flexible. In addition, the benefits of Greenland's reverse merger on capital market are also calculated in this study. The effects of private equity participating into SOE reform are specifically illustrated in this paper. According to the Greenland's view that PE shareholders, as strategic investors with rich experience and professional manager teams, would monitor the board of director, provide strategic advices, help the Group optimize management incentive and salary system. Furthermore, PE firms' global vision and resource would benefit Greenland Group expanding overseas business. The foreign capital participation problem is also discussed in this research, through the government's official attitude states foreign capital is very welcomed to participating into the reform, there are still some concerns existing there, more details will be presented later.

The contents are organized as follow. Chapter 2 illustrates an overall introduction of state-owned enterprises reform, Chapter 3 reviews theories of private equity's impacts on corporate governance and reform. The case study of Greenland Group is presented in Chapter 4 and the conclusion and limitation of this paper followed in Chapter 5.

## **CHAPTER 2 OVERALL INTRODUCTION OF CHINA STATE-OWNED ENTERPRISE REFORM**

### **Section 1. Previous state-owned enterprise reforms**

1978 is definitely a significant year in China's economy history. The Third Plenary Session of the 11th National Congress of the Chinese Communist Party was held, which decided to open China's economy to the outside world and started the reform from planned economy to market economy (Moore&Wen, 2006). Reforms can be mainly separated into three rounds. The first round SOE reform was during 1978-1992, the government loosened control on SOE managerial autonomy, pushed the separation of ownership and managerial autonomy, which were totally belonged to the



government before, and launched contractual management responsibility system to incent SOE maximum gains through profit sharing policy.

The second round reform started from 1992, Deng Xiaoping's Southern Tour speech significantly accelerated the speed of the SOE reform. With Deng's famous quotation "It doesn't matter if a cat is black or white, so long as it catches mice", China had no longer debated about whether the reform policies were socialist or capitalist, "socialist market system" (SSB, 1995) had become the new economy development goal. Business strategies and operation decisions could be decided by SOEs' own and these corporates began to be responsible for their own gains or losses, which encouraged or even forced those conservative SOEs participated in the fierce competition in market economy. Till 2002, China spent 10 years on building modern corporate system(Cho&Huang, 2012).

From 2003 to 2013 was the third round reform that focused on enhancing the reform of SOE property rights system. In order to better manage and supervise SOE assets, State-owned Assets Supervision and Administration Commission (SASAC) was established in 2003. The government and SASAC kept promoting SOE strategic reorganization and joint-stock system reform, and improve SOE bankruptcy regulation and law to completion. The modern corporate system was preliminary complicated during the ten years. The chart below is a simple summary of the history of SOE reform. The table showed in next page presents main contents of previous state-owned enterprise reforms.

Table 1 Main contents of previous state-owned enterprise reforms

1978-1992	<ul style="list-style-type: none"> <li>• Separated the SOEs' ownership and managerial autonomy.</li> <li>• Expanded SOEs' managerial autonomy on operating decisions.</li> <li>• Launched contractual management responsibility system and profit sharing policy.</li> </ul>
1992-2002	<ul style="list-style-type: none"> <li>• Built modern corporate system.</li> <li>• Stated property right reform, privatized parts of small and medium SOEs, encouraged diversifying property right and ownership of medium and large SOEs.</li> </ul>
2003-2013	<ul style="list-style-type: none"> <li>• Established the SASAC to enhance the management and supervision of state-owned assets.</li> <li>• Promoted SOE shareholding reform and accelerated marketization process.</li> </ul>

## Section 2. Status quo and problems of China stated-owned enterprise reform

Three rounds of market-oriented SOE reforms have made profound influences on China's growth prospects. According to the Ministry of Finance's report, by the end of 2013, over 90% of the SOE had completed shareholding reform; 378 SOEs financed RMB1514.5 billion through being listed on stock market; 57% of central State-Owned Enterprises (directly managed by the central government) had introduced private capital as shareholders to improve the mixed-ownership structure reform; those previous reforms broke SOE's conservative and low efficiency operation system, greatly released the vitality of private capital and stimulated the development of national capital market, as a consequence, China stock market had reached the peak in bull market in 2001 and 2007 respectively.

Financial performance is generally used to evaluate whether a reform is successful. The return on assets were increasing steadily since 2000 for both state and private enterprises, although the economy suffered a crush caused by the financial crisis in 2008, Chinese enterprises rebounded back rapidly less than two years. Furthermore, it was interesting that the ROA differences between state

and non-state firms mattered less before the financial crisis, after that an approximately 5% gap generated between SOEs and private firms. During the financial crisis, Chinese small and medium enterprises suffered great losses and plenty of SMEs went bankruptcy. The survivors kept seeking industrial transformation initiatives, from labor-intensive manufacturing to high value-added industry, while it was hard for those large-size state enterprises to do the update and transformation in short time, and some of them could only relied on the government subsidies to maintain daily operation instead of bankruptcy, therefore the state firms kept legging behind the private firms' performance.

Chart 1. Comparison of financial performance between SOEs and private firms



In the long term, the remarkable improvement of SOEs' performance was benefited by policy favoritism that ensured state enterprises taking the “strategic heights” of the economy (Zhang & Freestone, 2013). Private enterprises are restricted to entry into a wide range of industries which are “strategically important”, such as utilities service, petrochemical engineering and military industry (World Bank, 2012). Moreover, state enterprises stand in a better position in the market comparing with private firms, including government subsidies, low effective tax rates and resource extraction royalties (Huang, 2010). Indeed, SOEs enjoyed a privileged status in certain monopolistic markets created by the government, however, their performance even lagged behind private firms,

indicating that the reform has not completed yet, there are still serious problems existing in state enterprises.

Monopoly of state owned shares is the most noticeable problem in state enterprises. As the largest shareholder of a SOE, state assets surprisingly have the least control power because there is no specific person in charge; corporate supervisors are only agent sponsors of state assets and they focus on administrative appraisal rather than maximum efficiency and profitability. Furthermore, although a majority of state enterprises went IPO to deepen the shareholding reform and diversify the property rights, the monopoly of state owned shares problem has not been resolved at all, not even improvement, because there are larger amount of non-tradable shares in a SOE shareholding structure, the rest of tradable shares merely account for a small portion of the whole system, indicating that those market investors actually have little influence on the board's decision making, the corporate governance is exactly the same way as before, then what would be the meaning for implementing shareholding reform? In addition, state enterprises' monopolistic status in certain industries has hindered the developing of marketization economy and the building of modern corporate system. "Value creation" is the core variable to measure the performance of modern companies, and "value" is created through investing and manufacturing. However, for some monopolistic enterprises with incredible profitability, for example China Petrochemical Corporation (Sinopec Group), it was hard to tell that its enormous earnings are gained through excellent corporate governance or its monopolistic status in resource extraction. If the profits are rely on the monopolistic status, then meaning of establishing the appraisal mechanism of modern corporate system is doubtful.

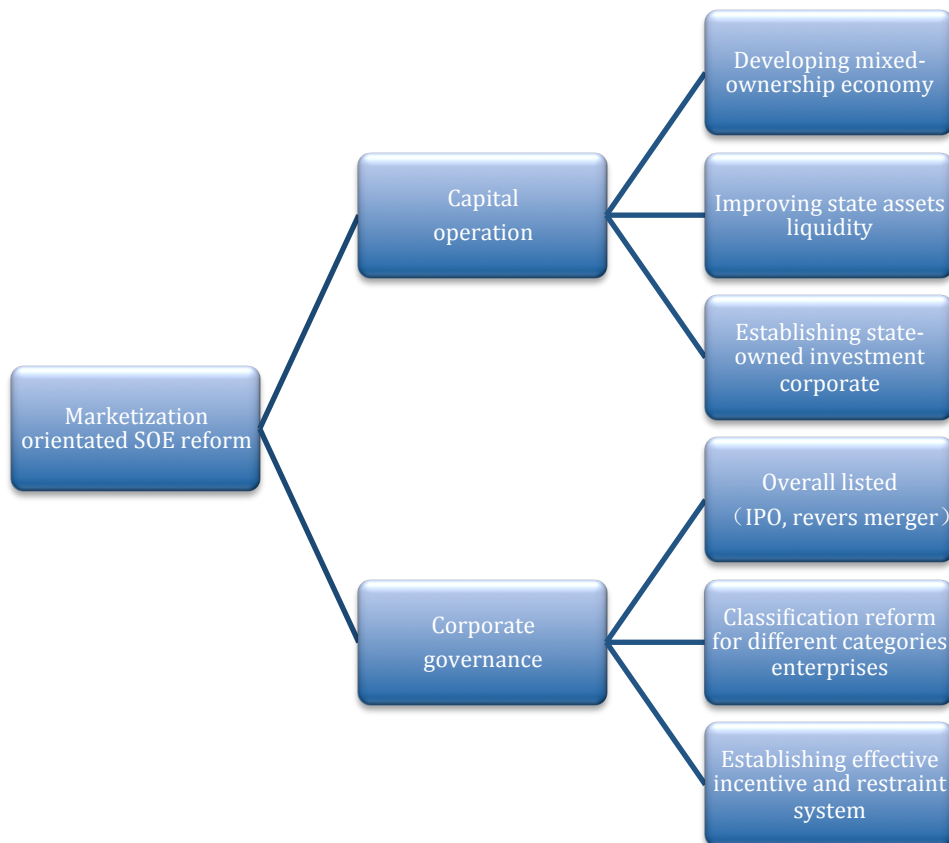
### **Section 3. The current round of state-owned enterprises reform**

China's new round of SOE reform started from 2014, and the Third Plenum, which was held in November 2014, set up the agenda for the current round of state enterprises reform aiming to increase SOEs' efficiency and attracting more private capital investments. According to an official

report of the UK government, by the end of first half of 2014, one third of central state enterprises claimed losses or earnings decline(www.gov.uk). Besides the underperformance, the profitability gap between state and private firms still exists, therefore, the most important content of current SOE reform plan is promoting mixed-ownership strategy, attracting private investors participating into corporate operation and market competition, that not only encourage companies increasing productively, but also provide a new financing way for local governments to get rid of their debts after the crack down on local government debt (www.gov.uk).

Marketization is the main point of this round of state enterprise reform, on internal corporate governance side, improving management efficiency through establishing equity incentive system, introducing strategic investors and overall listing on stock market; on external side, implementing mixed-ownership reform, improving corporate reorganization and stimulating state assets exiting from state enterprises.

Chart 2 Main contents of the marketization orientated State-Owned Enterprise reform



The central government has chosen six central SOEs as pilots to implement the reform plan showed in the chart above, they are: State Development and Investment Corporation, China National Cereals, Oils and Foodstuffs Corporation, China National Building Materials Group, China Energy Conservation and Environmental Protection Group, Xinxing Cathay International Group and China National Pharmaceutical Group(Gumede, 2015). In addition, local governments have already made some vigorous reform experiments ahead of time, for example, SINOPEC opened its downstream oil sales business to experiment mixed-ownership, and CITIC Group had listed on Hong Kong stock exchange as a whole through reverse merger. More researches and literature reviews about the main contents of the reform plan will be discussed in the following chapters.

#### **Section 4. Mixed-ownership reform**

Mixed-ownership economy, as the key point of this new round SOE reform, is not a new world because China has tried to diversify state corporates ownership since the second SOE reform. In 1994, the central government published the policy that privatized a part of small and medium SOEs while still strictly controlled the large state enterprises, and the policy was summarized as “grasp the large and release the small”. For the current round SOE reform, diversified ownership policy is improved and implemented deeply, the mixed-ownership reform will started from those large state enterprises, especially which are considered as “strategically important” such as oil, transportation and telecommunication. The reform plan requires SOEs maintaining the influential status in the overall economy meanwhile withdrawing some competitive markets (Dusek *et al*, 2015). However, there is still an argue about whether SOEs should withdraw from competitive markets, some people claim that state enterprises should withdraw from those competitive industries, such as real estate and hospitality, and invest more in infrastructure construction; while others insist that there is no need for state firm to withdraw the competition as long as the government cancels preferential policies for SOEs. 80 projects from state-dominated industries such as energy, pharmacy and other industries have been selected to open to private investors. And soon afterwards six central state enterprises have been chosen as pilots for corporate the mixed-ownership reform.

For easier understanding, corporate mixed-ownership can be considered as partial privatization that allows private investors hold state enterprises' shares which are usually solely state-funded before. It is hard for China to fully privatize state enterprises because of their large sizes and the government policy guidance. In the whole A-share stock market approximately half of the listed companies' shares are effectively owned by the state(Sam, 2011). Meanwhile, SOEs have the duty to manage critical resources, preserve employment and improve regional development(Boardman *et al*, 1986 ). A similar pattern can also be found in Singapore, whose almost 60% GDP was attributed to State-Owned Enterprises, and part of the main state enterprises are partially hold by the government, hence this pattern could be a reference for China's reform (United States and State Department, 2001).

The implementing of mixed-ownership reform would end up the situation that the director of board is wholly controlled by the state assigned managers, private shareholders would join into internal board and monitoring system and effect the operational decision making (Cragg &Dyck, 1999). A noticeable problem brought by the state sole ownership is that no manager would use his/her rights to monitor the behavior of the state enterprises because property right is not clear that diffuses to all social members and nobody has the right to deal with his/her shares, therefore, they have no pressure or incentives to improve efficiency(Alchian &Demsets, 1973). However, when private investors become shareholders, they have full rights to decide whether to buy or sell the shares, hence they have more incentives to stimulate the company to achieve better performance maximizing its profitability (Henry, 1999). Megginson *et al*(2006) state that privatized companies are more profitable and efficient than state enterprises, through testing 3 years pre and post privatization performance and operating ratios and comparing with the country industry levels. Mok and Chau's(2003) research also supports privatization benefits firm performance. They examine the data of companies listed in Hong Kong stock market and claim that partial privatized enterprises have more efficiency than state enterprises, although those SOEs are more profitable. On the other hand, there are other researchers drew opposite conclusions. Oum *et al*. (2006) made an empirical study on

116 airports found out solely state owned airports actually performed more efficient than those partial privatized airports. Boardman and Vining (1989) support this conclusion with a test result of 500 firms in 1983.

There are already some pioneers for the mixed-ownership reform, for example, China Petroleum & Chemical Corporation(Sinopec). Sinopec sold its 29.99% of its downstream oil sale and distribution business to 25 non-state institutions, including private equities, private firms and social welfare funds. This is a positive action for the privileged mega SOE to break the monopolistic market initially, and the private placement were significantly oversubscribed(Dusek *et al*, 2015). Another thing has to be mentioned that although foreign investors were invited to participate the bidding, none of them won the bid. The Minister Li Keqiang determined to complete this round of reform almost without the supports of foreign capital, therefore, 96% of the bidding asset was sold to mainland and Hong Kong institutions, even at a lower price than expected(Lin, 2014).

### **Section 5. Reverse merger**

A fact we have to admit that although China's economy has been developing in a high speed, the financial performance and efficiency of state enterprises have not increased in the same pace. Therefore, to be listed in the stock market is a proper way to extend financing channels; build modern corporate system, establish corporate image and improve the efficiency of enterprises. However, the government's strictly IPO reviewing system makes it be a high cost long time process so that a lot of firms have to withdraw IPO choosing reverse merger to go public instead.

Reverse merger is an acquisition of a public firm by a private firm so that the private firm can go public and being the surviving public entity through a less time and expenses cost way. Unlike IPO, reverse merger cannot help the company financing capital directly from stock market though the new listed firm can raise money through capital market later(Gleason *et al*,2005). The general process of reverse merger is that the private firm purchases control of the public firm, which is called "shell"



company, the private firm obtains a majority of the shares (above 51%) of the public firm, than merger it and control its board of directors.

The motivation for companies choosing reverse merger, also known as “back door listing”, is mainly because it is a shorter, easier, and lower cost way to go public. Compared with IPO, reverse merger costs substantially less expensive. Ritter (1998) cites that 11% of the average gross spreads would be paid for the IPO, which contains underwriting, legal, auditing fees and etc. While the combined fees of reverse merger would only cost about 2.72% of the transaction value for the target company and acquires. In terms of time cost, a well-operated reverse merger can be closed in no longer than three months while a typical IPO generally takes six to nine months (Arellano-Ostoa & Brusco, 2002). When a firm decides to IPO, it has to withstand regular audits, information disclosure requirements and the supervision of SEC, hence it is possible that the firm fail the IPO procession, whereas reverse merger can help companies to avoid these initial listing requirements, and access to the capital market through a “back door” (Arellano-Ostoa & Brusco, 2002; Frederick *et al*, 2008). In other words, IPO is more risky and uncertain, and reverse merger listing can be considered as a combination of two entities, once the target and acquire agreed, the deal has a high possibility of completion (Gleason *et al*, 2005).

Literatures indicate that reverse merger is more attractive to small companies, but why China’s large size state enterprises would like to choose reverse takeover? The regulators’ examining system might be the main reason. In order to root out the fraudulent statements, the companies, which apply listing, have to be closely examined their annual reports by underwriters and China Securities Regulatory Commission. And the listing requirements are quite strict, for example, three consecutive years of profitable is required while some of SOEs cannot meet this requirement. Furthermore, a backlog has been created since so many companies applied IPO and the examining system makes the whole listing process take longer time. In addition, for mostly of state enterprises, they dose not need to raise more capital through going public but to complete an organizational reform and build a modern corporate system. Therefore, reverse merger is a better choice for SOEs to go public.

An empirical case is that CITIC Group Corporation (Citic) listed in Hong Kong Stock Exchange through subsidiary Citic Pacific in 2014. Citic is China's biggest conglomerate, and it runs business involving financial service, energy, manufacturing, real estate and other fields in China and overseas(www.citic.com). Citic Pacific paid its parent company cash and issued shares for the parent assets transection. Meanwhile, it had to issue new shares to the market to fulfill the HK Stock Exchange requirement that a listed company should have a minimum public float of 15%(Levin, 2014). Not only went listed in HK, but also moved its headquarter from Beijing to Hong Kong, Citic Group had make a good example for deepening China SOEs reform, to initiatively adopt a more free market and sound management mechanism in order to change the inefficiency and poor oversight of state enterprise.

## **Section 6. Corporate governance reform**

Besides mixed-ownership and overall listing, corporate governance is also a main topic of the current round reform. And in order to accelerate establishing modern corporate system, this round of internal management reform contains three main aspects—equity incentive, salary system and professional managers engage mechanism.

No proper incentive system is one of the principle reasons leading the low efficiency of state enterprises. State enterprises runs by the government, they are state assets, while in China state assets belong to all the national people legally, this ambiguous property right problem makes managers just be an “agent” to operate companies, therefore, no one really cares about the profits increase or inefficiency(Guo,2014). Now it is necessary to establish efficient incentive systems to improve the SOE performance.

Stock grants has been generally selected as an incentive for managers, and prior researches shown that optimal equity incentives vary with companies' characteristics(Demsetz &Lehn ,1985). Murphy(1998) claims that the higher stock-based compensation, the better firm financial

performance. Core and Guay's(1999) study provide evidence for the efficiency of stock grants incentives. Guo(2014) states that in the case of using stock option incentive, managers would pay more attention on the future value creation rather than short-sight decisions, which would benefit the long-term development of the firm.

Most state enterprises' salary is generally low and fixed (except some resource companies like Sinopec), which leads agency problem that managers focus on entrenching their power and privilege, longing for 'Gray incomes' rather than find out profit growing points (Guo,2014). The non-performance related salary system is not fair to employees who make more contribution to the firm, and less attractive salary would also cause the brain drain. Martocchio (2002) argues that strategic compensation should be part of the humane resource management system, emphasized the importance of relating staff performance and salary. Montemayor's research (2003) consist with this theory and provides evidence for the inferior company performance is related with the lack of the fit between corporate stagey and efficient salary system.

Furthermore, currently, the top managers of state enterprises are directly appointed by the government, usually they are government officials, who might lack of enough knowledge of operating a corporate, so it is hard to convince shareholders and the public that the manager is qualified to run the company(Lu,2009) Therefore, the next move of state enterprises human resource reform is adapt to professional manager market, reduce the government administrative intervention, introduce competition mechanism in order to incentive managers' creativity and improve the corporate performance(Guo,2014).

## **CHAPTER 3 EFFECTS OF PRIVATE EQUITY ON CORPORATE AND REFORM**

## **Section 1. General impacts of private equity on corporate performance**

Private equity refers to an asset class that not quoted on public stock exchange, and it invests in unlisted companies through negotiated process (Bance,2002). The investment categories of private equity include leveraged buyout, venture capital, M&A and restructuring (Private equity and leveraged finance markets,2008). In the recent years, there is a substantial increase in private equity takeovers volumes, especially in China, so next we will discuss about the impacts of private equity on corporates performance.

Prior researches have made substantial tests on the effects of private equity on corporate governance. Jensen(1989) cites that private equity can improve corporate performance through monitoring managers and restricting the use of free cash flow. Kaplan's(1989) study confirms the performance increasing theory, he tested 76 management buyout firms during 1980 to 1986, and the results showed that main financial ratios, such as free cash flow and operating income, have all increased three years after the transaction. Moreover, in manufactory industry, private equity-invested companies experienced a significant productivity increase(Davis *et al.*2009). Private equity does not only have incentives in corporate short-term performance, but also results to a substantial increase in firm's long-term innovation(Lerner,2008). Besides corporates experience better development, shareholders can enjoy the benefits brought by PE buyout as well, 40% premium has been received by shareholders of 177 UK buyout transections(Renneboog,2007). However, studies in the recent decade indicate that private equity does not ensure an increase in corporate profitability. Leslie and Oyer (2008) examined 144 LBO in the US during 1996 to 2004 and no evidence has been found to support private equity buyout would result more profitability. Guo *et al.*(2009) state that there is no significant difference on operating performance of the buyout company.

Private equity can also make contribution on reducing agency costs. The companies' debt service payments generated by LBO ensure managers concentrate on operating business more effectively in order to avoid bankruptcy, rather than use addicted into building their own empire with companies'

capital, so that to reduce agency costs by restricting the misallocation of free cash flow(Jensen,1989). Galai and Masulis(1976) demonstrates that for those managers who hold large equity positions have more incentives to reduce costs and make the firm performance better, because company performance and stock price are closely related, the highlighted sensitivity of stock price simulates managers to work harder on profitability improvement (Masulis&Thomas, 2009).

Monitoring on board of directors after the acquisition transection is considered to result to the reduction of agency cost. The stronger financial incentives and internal reporting system lead to more strictly rights control so that reduce free rider problem(Cotter&Peck,2001). Incompetent senior executives will be quickly replaced by highly talented ones, and the “performance-sensitive compensation” stimulates managers to make greater efforts on improving corporate financial performance(Kalpan& Per Strömberg, 2009).

An LBO usually requires the private company borrowing a large amount of capital to purchase the publicly held stocks, as a consequence, considerable debt serving obligations generated by this high leverage will bring tax deductions for the acquired company. Tax deductions bring benefits on free cash flow so that the capital can be used for company’s future growth and create more profits, therefore, Ronneboog and Simons(2005) even argue this might be a main reason for a buyout transection since these benefits can be forecasted and appropriated in the competitive market.

Takeover defense is another impact that could be brought by private equity. When a target firm is facing hostile takeover, it may look for private equity fund to be an antitakeover defending against the hostile takeover through privatization, especially through a management buyout(Lowenstein,1985). In the case that small and middle enterprises threatened by hedge funds, these firms have more motivation to make transection with private equity in order to avoid lose the control of company. Brav *et al* (2008)provide robust evidence for this theme, they claim private equity buyout frequently happened after firms are attempted by hedge funds.

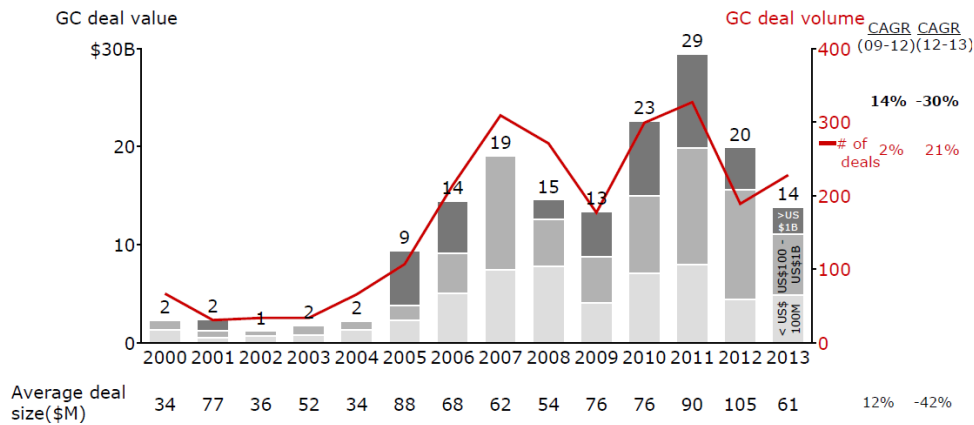
For listed companies in the US, going private is a way to avoid paying expensive compliance costs of Sarbanes-Oxley Act. Fidrmuc *et al*(2007) state that it is hard for those small public technology firms to afford the costly compliance fees after the Internet bubble in 2001, they had to choose going private when facing increasing compliance costs while declining in trading volume. However, Bartlett(2009) argue that costs might not be the cause for privatization because some taken private firms still provide reports for Sarbanes-Oxley Act restrictions. Leuz(2009) cites that the boom of private equity in the worldwide has no relationship with Sarbanes-Oxley Act, and he suggests more available capital for leveraged buyout might explain the increase of LBO activity. Another benefit brought by going private is no more public information disclosure, and this would save a lot time for managers to explain their actions to the public or make efforts on maintaining investor relations, furthermore, some sensitive information do not have to be disclosure to public investors(Masulis&Thomas, 2009).

## **Section 2. Development of private equity in China**

Private equity does not have a long history in China, before 2004, venture capital is the main investment method, while recent years private equity experienced a boom with China's incredible economic growth speed, till 2005, China has become the third largest private equity market in the world.

Although the first venture capital fund was established in 1985, the rapidly increase of PE industry started from 2004. Some famous buyout cases completed by international PE fund, such as Blackstone and Carlyle, made examples for domestic private equity firms, and since then, domestic PE funds began developing rapidly. Because of the impact by 2008 financial crisis, foreign PE funds slow down their expansion speed in China, and in 2009, RMB funds issued by domestic PE firms first dominated the market.

Chart3 Deal volume in Greater China 2000-2013



Note: Exits and Investments with announced deal value >\$10M only, done in APAC; Excludes real estate, hotels & lodging, infrastructure, and large domestic transfers from SWF to government  
Source: AVCJ

A surge can be found in 2011 but soon followed by a significant decline in deal volume caused by temporary IPO prohibition. With the lifted of the IPO ban, China’s investment market experienced an incredible increase, especially in venture capital market.

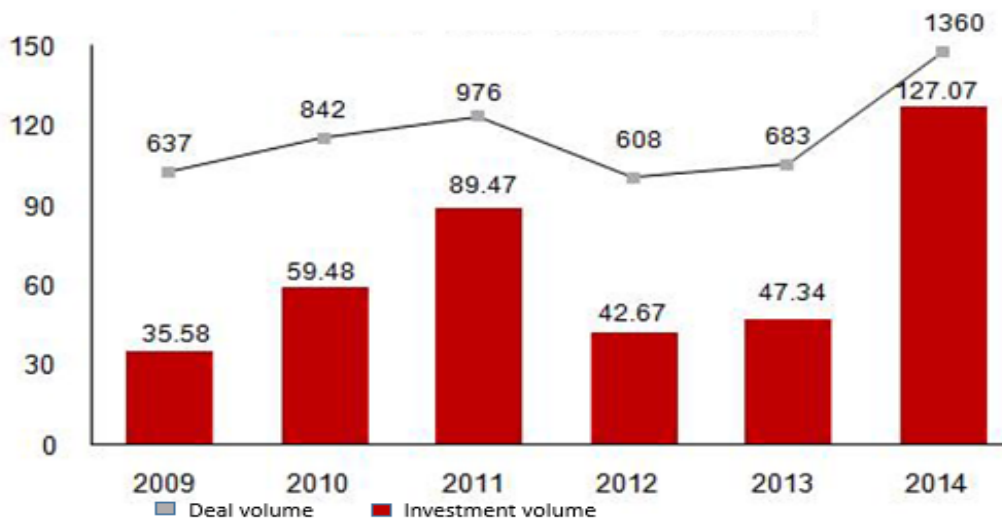
Table 2 Deal and capital volume in VC/PE 2013-2014

	Volume	2014	2013
<b>Venture Capital</b>	Deal	1360	683
	Capital	\$12.7 billion	\$4.7 billion
<b>Private Equity</b>	Deal	280	325
	Volume	\$34 billion	\$21.5 billion

CVSource 2015

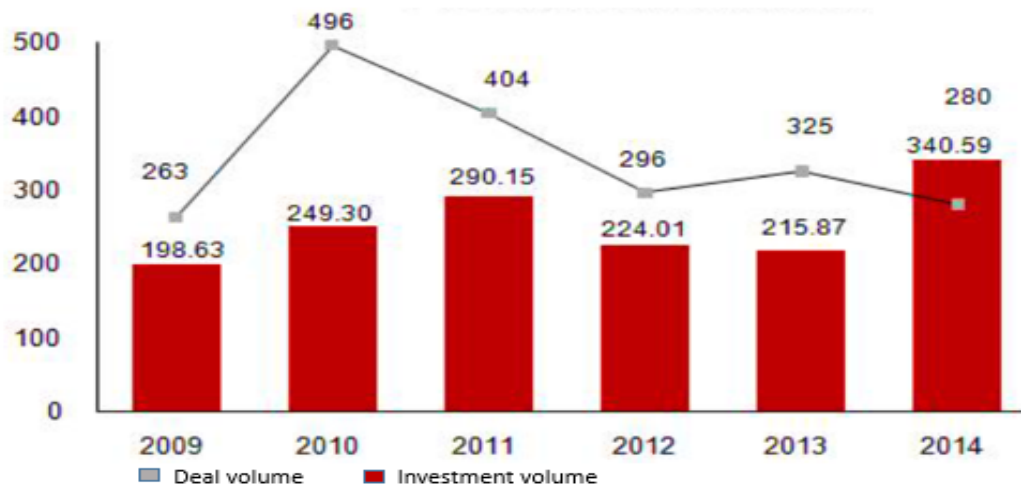
We can see from Table2 that in 2014 venture capital investment volume almost tripled the 2013 market, and although the deal volume has a slightly decline compared to 2013, the investment capital amount still increased than the last year.

Chart4 China VC market volume 2009-2014



CVSource 2015

Chart5 China PE market volume 2009-2014



CVSource 2015

The release of IPO ban and the burst of mobile Internet development contributed on the booming of VC/PE market in China. Another factor that drove the PE flourishing is limited access for investors into public market, in China's vast economy, only a few markets are investable. And in terms of stock market, 75% of market capitalization is traded in A-Share market, where foreign investment capital is strictly controlled. Moreover, pension managers become more comfortable with private equity in recent years. By the end of 2012, China National Social Security Fund(NSSF) claimed its



private equity allocation by more than 50%, and had invested about \$3.7billion, and there are substantial room for investment volume increase form pension fund. In additional, the long-term under-allocated in emerging markets would keep attracting foreign capital shifting to China in order to take the advantages of high speed economic growth(Private equity roundup — China, 2012).

### **Section 3. Effects of private equity in the current round of SOE reform**

General effects of private equity have been deeply researched by prior scholars whereas what kind of role that PE can play in SOE reform is still a new topic.

For corporate governance aspect, private equity not only plays a financial investor role to provide capital that needed during the reform procedure, but also as a strategic investor to participate into corporate operating and promote the establish of modern corporate system. Sinopec's case has shown that private equity can make contribution on state enterprise missed-ownership reform through partial privatization, meanwhile, it can provide a channel for state assets smoothly existing from SOEs, effectively eases the great pressure brought by "reduction of state-owned shares" plan in securities markets. Ma(2010) demonstrates that the external force brought by private equity would break the inherent pattern of interests and improve state enterprises institutional change in order to meet the requirements for listing in stock market. Qiao(2007) cites that introducing foreign private equity firms would broader financing channels for state enterprises and promote SOEs' ownership diversification. Furthermore, experienced private equity firms would encourage implementing advanced corporate governance theories and help state enterprises overall listing in stock markets.

Nowadays, China is experiencing industry updating and transforming process, private equity is needed to help corporates complete M&A transections, meanwhile, PE funds can promote the development of firms at different stages(Wu, 2007). Wang and Zhao(2006)analyze the foreign PE participating in SOE reform problem, and claim that as strategic investors, foreign private equity firms can resolve some problems during the reform procedure in a certain degree.

In terms of industry integration, Liu and Liu(2008) argue that private equity can combine industry and capital advantages so that create more room for economic growth. Currently, establishing “Listed firm+PE” industry fund has been a big trend in China capital market, 133 industry funds have been set up in 2014 and 80% of industry funds size are ¥100-1000 million yuan. This kind of industry fund focus on making transactions in the listed firms’ manufacture chain, merger and acquires related firms in the listed companies’ up and down stream. The funds’ investments based on the strategic development plan of the listed firm in order to help them complete business expansion or transformation, especially on those traditional manufactory listed firms. Private equity firms hold the domain position in the industry funds investments, integrate sources and provide advices or financial supports for the M&A trisections.

## **CHAPTER 4 CASE STUDY OF GREENLAND GROUP REFORM**

Since this round of SOE reform just started last year, there is not enough qualified financial data for doing quantitative regression, furthermore, the deeper meaning and effects of the reform cannot merely evaluated by statistical results. Therefore, this paper will use qualitative method to research the problems about this reform. A case study is conducted and a typical famous state enterprise—Greenland Group has been chosen as the sample. I had in-depth interviews with Greenland’s top manager and Shanghai government officer in order to analyze the research problems— how private equity could participate into the SOE reform, details will be illustrated in Chapter 4.3 and Chapter4.4.

### **Section 1. Introduction of Greenland Group**

As one of the largest state enterprises in China, Greenland Group is established in 1992 in Shanghai, and takes the 268<sup>th</sup> place in Fortune Global 500. Its business domain is real estate, and integrated development of related business, including finance, hospitality, energy and metro construction. Greenland Group’s projects cover 80 main cities in 29 provinces, and it plays a leader role in four construction area: ultra-high rise buildings, urban complex projects, high speed rail station and

industrial park. Greenland Group also operates expands its business worldwide, and successfully entered in the US, Russia, UK and Australia, and 13 cities in four continents.

Chart 6 Greenland Overseas



Source: [www.greenlandsc.com](http://www.greenlandsc.com)

Through Greenland Group has not went public in mainland China, “Greenland Hong Kong Holdings”(00337) has listed in Hong Kong Stock Exchange in 2013 through reverse merger, which provides experience for Greenland overall listed in China A-Share Exchange. By the end of 2014 fiscal year, Greenland Group announced an operating income of ¥402.1 billion yuan and ¥24.2 billion yuan profits. It is estimated that until 2020, the groups operating income and profits will reach ¥800 billion and ¥50 billion, respectively, meanwhile, the group will built itself into an outstanding international corporate and complete transforming from “China’s Greenland” to “World’s Greenland” ([www.greenlandsc.com](http://www.greenlandsc.com), 2015) .

Greenland Group has become a conglomerate through 23 years’ development, it is like “Zaibatsu” in Japan that run business covered different industries. The business domain of Greenland is real estate and has been the leading operator in this industry, for intense, 23 ultra-high-rises in both China and

overseas have been constructed by Greenland and become landmarks of those cities. Owned 70 hotels all over the world(including JW Marriott and Intercontinental Hotel), Greenland keeps expanding the scale and enhance the strength in hospitality industry, at the meantime, the Group implements self-owned brand strategy and established its own luxury hotel brand “Primus” and a business brand called “The Qube”. The ambition of Greenland Group in financial industry is to realize a “Big Finance” concept that involving asset management, investment bank, loan firms and trust companies, and till 2014, the amount of its finance business has achieved 20 billion yuan. Greenland’s energy business has been growing in an incredible speed and now the Group has owned a complete industry chain of coal and crude oil, from production to distribution. As we can see from the introduction that Greenland Group is a typical well-operated State-Owned Enterprise, and it chooses to reform initiatively in order to fully participate into the capital market making a good example of the SOE reform.

## **Section 2. Brief illustration of Greenland Group’s reform**

The reform for a large conglomerate such as Greenland is a complex restructure process, and Greenland Group will complete mixed-ownership reform and overall listing through this major assets reorganization. The reform is divided into tree main steps.

### **First step: Introduced private equity firms as public shareholders**

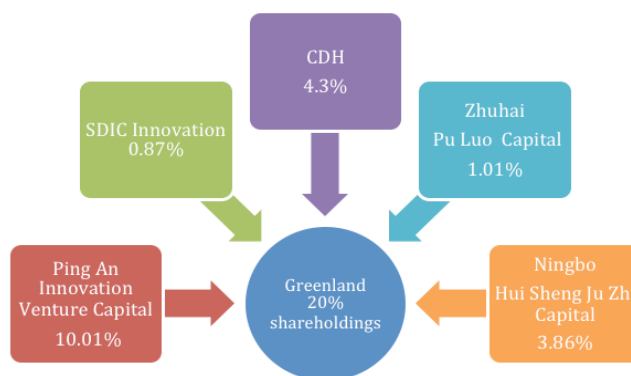
Before the reform, as a state enterprise, Greenland Group is owned by Shanghai State-owned Assets Supervision and Administration Commission (SASAC) through its two wholly-owned subsidiary companies—Shanghai Real Estate Group and Shanghai Municipal Investment Group, and the rest part of shares belongs to Employee Stock Ownership Plan(ESOP).

Chart 7 Original shareholdings before the reform



According to China’s regulation, firm’s go listing procedure will be suspended if the public shareholding ratio is under 10% of all the equity amount, therefore, in order to complete overall listing smoothly, the first step of Greenland’s reform is introducing external investors. On 25th November, 2013, Greenland issued 2.1 billion shares at 5.62 yuan per share to the public, which took 20% proportion of overall equity amount. Five famous private equity firms won the bid and injected 11.802 billion yuan into Greenland Group to help it promote the reform, and thanks to these private equity shareholders, Greenland could smoothly move to the next step of the restructure and not worried about being suspended listing process because of lacking public shareholdings.

Chart 8 Shareholdings of five private equity firms



Source: ifeng.com

**Second step: Establish Shanghai Gelinlan Company**

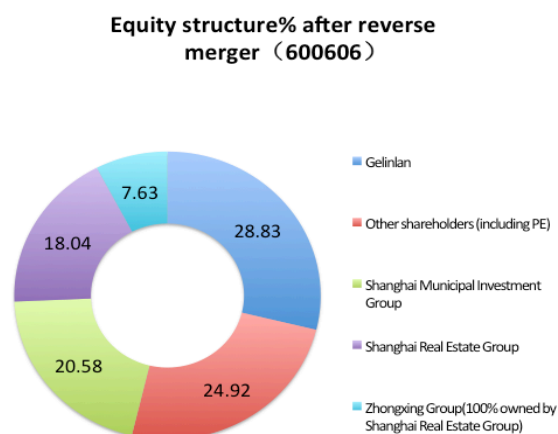
In order to protect the shareholdings belong to ESOP from being gobble up during the

mixed-ownership reform, Greenland set up Shanghai Gelinlan Company to control all the management and employees' shareholdings in 2014, and the name "Gelinlan" is sounded similar to "Greenland" in Chinese. Shanghai Gelinlan controls 37.66 million yuan employees' shareholdings, and account for 28.83% of the new Greenland Group after reorganization.

### Third Step: Reverse merger transaction with Jinfeng Investment (600606)

According to the published transection plan, the reverse merger asset replacement happened first in the procedure, Jinfeng Investment was the shell company for Greenland Group. All of Jinfeng Investment's assets (2.3 billion yuan) were replaced by equivalent amount of Greenland's shares. After that, Jinfeng Investment issued 11.326 billion new shares additional targeted Greenland Group at 5.58 yuan per share in order to acquire 100% equity shareholdings of Greenland. The seasoned offering was about 63.2 billion yuan, and the total capital volume reached 66.5 billion yuan, and became the largest reverse merger transaction in China as a consequence. When the transection completed, none of the major shareholders, such as Shanghai Real Estate, Shanghai Municipal Investment Group and Shanghai Gelinlan Company could become control relationship with the new Greenland Group with less than 30% shareholdings, which means that Greenland would successfully become a mixed-ownership corporate from a typical state-owned enterprise.

Chart 9 Equity structure after reverse merger Jinfeng Investment



Source: ifeng.com

### **Section 3. Interview with Greenland Group manager**

In order to research theme, I had an in-depth interview with Greenland Group's Office Director Xiaodong. Wang, who is managing affairs of boards of shareholders, directors and supervision, also responsible for administration affairs of the overall Group, including routine work, public relations, conference arrangement, custody classified documents and so on...it is like a“常務取締役” level position in Japanese company. Contents below contain Mr. Wang's response and my supplements.

#### **1. What is the point of completing mixed-ownership reform and reverse merger for both Greenland Group itself and the capital market?**

This round of reorganization will update and deepen the Group's mixed-ownership reform, and release enterprise's vitality and competitive strength. Specifically, source advantages brought by different backgrounds shareholders' would be highlighted, and the operational efficiency would increase through resources complementary and advantages assembling. Also, the mixed-ownership breaks up the old order in management and improves marketization process of those conservative state enterprises, consequently, their decision making would become more scientific, independent and flexible. Furthermore, more regulatory operation, incentive mechanism and information disclosure brought by mixed-ownership reform would make contribution to healthy development of large state enterprises. Right now, China is experiencing economy transition, so it is wise for Greenland to swim with the tide implementing initially rather than stay with the old-school thoughts and eliminated by the fierce market competition.

China's state-owned economy has particularities, most of SOEs are in pillar industries which indicates that we cannot simply copy the western countries ways or Japan's way that private a whole state enterprise once and for all. Therefore, mixed-ownership is practical measure that fits national conditions. It ensures the dominant position of state assets in national economy, meanwhile, it exploits the advantages of marketization, efficient and flexible brought by mixed-ownership, fully

combined “state-owned system” with “market system” in order to release state assets’ influence and driving force.

Noticeably, in capital market, Greenland’s reform is a triple-win for state assets, PE and ESOP, the continues rising of Jinfeng Investment share price brought great fortune since China Securities Regulatory approved the reverse merger transaction. According to the transaction announcement published by Jinfeng Investment(after the reverse merger has been completed), the total share volume is 11.8 billion, and by the end of 8<sup>th</sup> May, its stock price is has already become to 31.1 yuan, therefore, the overall market value of is 366.98 billion yuan, which will be largest real estate listed company in China. The State-owned Assets Supervision and Administration Commission(SASAC) controls 46.25% of the reorganized group shares through three corporates, so the value should be  $366.98 \times 46.25\% = 169.7$  billion yuan. Before this transaction, the SASAC held 60.68% of Greenland Group, and according to the official evaluation report, Greenland’s was estimated as 46.4 billion yuan, the shares value was 28.2 billion yuan consequently. At the same time, SASAC had 201 million shares of Jinfeng Investment, about 1.06 billion yuan based on the 5.23 yuan per share before suspension. Therefore, the great capital appreciation for SASAC brought by the successfully reverse merger would be  $169.7 - 28.2 - 1.06 = 140.44$  billion yuan.

Meanwhile, for the private equity companies, the smoothly transection bring them 7 times benefits compared with their costs. For instance, Pin An Innovation Venture Capital, Ningbo Hui Sheng Ju Zhi Capital and CDH paid 5.8 billion, 2.2 billion and 2.5 billion respectively for bidding Greenland shares at 5.62 yuan per share, and they each holds 10.01%, 3.86% and 4.3% of group shares after the transaction, hence, the market value of their shares have already become to 37 billion, 14.17 billion and 15 billion respectively.

In terms of Gelinlan Company, which is the founded for management equity incentive, it holds 28.83% of the reformed group shares, which is  $366.98 \times 28.83\% = 105.8$  billion yuan. So each of the



982 members of Gelinlan Company will hold shares' market value equivalent to 107.7 million yuan.

## **2. Why Greenland decided to go public through reverse merger instead of IPO?**

### **What are the difficulties and obstructions during reverse merger process?**

It is quite a long and tortuous progress of Greenland's going public. At first, Greenland Group had decided to go IPO in 2007, however, the unexpected financial crisis hindered the plan. And in 2008, China Securities Regulatory Commission announced to tighten the fundraising of real estate enterprises, and another document about tightening real estate companies financing through going public was issued in 2010, hence the attitude and policy of regulatory department break up dreams of real estate enterprises' that raising enormous capital through IPO, and the influence last till now, so in some degree the Group has to chose reverse merger to achieve its goal.

The Group's complicated shareholding structure made the whole reverse merger transection a complex process. The state owned 51% shares of Greenland Group, and employees' shareholding commission controlled 46% equities, which was considered as an obstructer to the transection. Meanwhile, its diversified business also made the process harder. The reorganization involved so many aspects, the interests allocation and balance required a considerable long time. In terms of technical operation, Greenland would transmit to Jinfeng Investment about 75billion yuan, and than, if the price of shell firm's additional target issued stock was low, than the market share price would be low as well, which would lead to a loss of state assets; while if the additional issued stock price was quite high, than Greenland would replaced less shares which was not an expected outcome.

## **3. Greenland Group chose PE firms as public investors rather than other kind of institutional investors, such as securities company, pension fund or insurance firm, so**

**what kind of advantages and impacts that PE shareholders will bring to the Group reform?**

Private equity firms are playing both financial investor and strategic investor role in Group's operation. It is true that all of the institutional investors mentioned in the question can provide enough capital to financing the reform and business operation, and monitoring the board of director as major shareholders, whereas PE firms are more competitive in giving strategic advices. Generally, private firms have more professional manager teams, which have rich and professional capital operation experience, as well as corporate management experience. Private equity can effectively improve the management mechanism problems which existing in traditional state enterprises for long period, and this point is the biggest advantage that PE firms have. PE also provide other value added service, for example, global vision and resource, which would help Greenland Group expend overseas business with professional consulting advice. Moreover, PE firms could help improve the Group's equity incentive system and salary system, to really participate into changing the old-school operational mode of Greenland Group, and that is what other investment institutions cannot do.

I (Mr. Wang) believe you(the author) have noticed that it has become a trend in the market that listed companies cooperate with PE to establish industrial funds, and invited private firms as major shareholders might provide a chance for Greenland to consider about launching industrial fund with these PE companies.

“Listed company +PE” industrial fund usually does equity investment in emerging industries or fixed investment projects, and exit ways include IPO, M&A, share transfer and share repurchase. Industrial fund' investment themes contain venture capital, private equity, M&A, real estate fund and etc. Among these themes, “Listed company+PE” merger industrial fund gets most attention. A simply operational flow is as followed:

- 1) The listed company and PE firm co-financing establish the industrial fund, and listed company as LP, PE as GP.
- 2) PE firm response to raise the rest capital that required by the merger.
- 3) PE firm is in charge of the capital operation from evaluation to investment of merger projects.
- 4) When is ripe for PE exiting from the project, PE transfer the project to listed company through this industrial fund and exit smoothly.

According to CVSource database that from January 2014 to February 2015, 173 listed companies cooperated with PE establishing industrial funds, meaning that 6.6% of the overall A-share listed firms stated running this business in only one year (“Listed company+PE” industrial fund research report, 2015). This kind of new cooperate mode is a win-win for both listed company and PE firm. Traditional industries listed companies hope to promote transformation and updating through M&A, meanwhile, emerging industries firms hope to access and control the latest technology and industry dynamics, in order to improve its strategic layout by merger up/downstream relative companies. Moreover, the required transection capital can be financed through IPO or additional stock issuance. On PE firms’ aspect, sell the project to listed firms might release the exit pressure brought by low IPO issue rate. Furthermore, these years pre-IPO investment mode, which was an extremely popular investment method 2 or 3 years ago, experienced a significantly decline due to policies and market environment, thus PE firms have to find new investment method such as merger and acquisition. Another advantage that should be motioned is that it would be easier for PE firms raising money because this industrial fund have the listed companies’ reputation endorsement.

- 4. Recently, a majority of people in Mainland China and Taiwan are attracted to invest real estate in Japan, therefore, as the largest international real estate company in China, what is Greenland’s next step in expedition abroad business?**

In 2014 Greenland's overseas business experienced a boost that achieved 467% increase compared to 2013, and earned 15.3 billion yuan foreign sales business, Greenland Group has already become the largest real estate group in the world. Group's goal in 2015 is pursuing 30 billion yuan foreign sale earnings and keeping the competitive advantages in overseas business. Greenland Group pays lots of attention the demands of people that invest in foreign real estate, therefore, in order to provide better service for these clients, Group decides to launch a one-stop platform including house purchasing, immigration, education, medical treatment and other service. As we known that during the abroad property purchasing process, there are plenty of uncertain risks that effect investor's decision. For instance, capital risk, which might caused by unqualified property agencies; profit risk, leading by unprofessional evaluation and other influence factors; legal risk, that investors are not familiar with foreign laws, and the last management risk, meaning that it is hard to manage your overseas property remotely. In additional, psychologically, people will always trust their domestic companies when dealing with foreign affairs. Hence, Greenland Group's one-stop platform provides full range of service for Chinese investors on purchasing properties abroad. And the platform has sign the cooperation contrast with 14 famous companies in education, travelling, legal, medical and other industries so that to give investors full range of consulting advises about living abroad.

Chart 10 14 companies that cooperate with one-stop service platform



Source: <http://house.baidu.com/>

#### **Section 4. Interview with Shanghai State-owned Assets Supervision and Administration Commission officer**

All of the state-owned enterprises are under the control of Shanghai State-owned Assets Supervision and Administration Commission, which make reform plan and leads enterprises' reorganization turn to mixed-ownership. Thus, I believe it is necessary to interview and relevant officer in Shanghai State-owned Assets Supervision and Administration Commission(SASAC) so that to have more comprehensive perspective on the state enterprises reform issue. Fortunately, I had a chance to discuss with a highly relevant officer who works in SASAC State-Owned Enterprise Reform Department, whereas the name and position of this officer is kept classified in this dissertation because of certain government information disclosure policies.

##### **1. What are Shanghai government's perspectives on the current round of state-owned enterprise reform? What kinds of results that government expects to achieve during leading state enterprises implementing reform?**

Shanghai government has already published guidance on local state enterprises' reform, and according to the guidance, the government hopes to improve SOEs' management mechanism; reduce administration interference on corporate governance; and increase enterprise vitality and competitive strength. As you know that we SASAC pay more attention in state assets management rather than concrete corporate governance, so the government determines to clarify its responsibilities that exits state assets from SOEs generally and delegates decision power reducing administration interference on enterprise internal management. At the same time, the government hope to optimize state assets' strategic layouts through this round of reform, centralizing resources and inclining policies in order to allocate 80% of state assets centralized in strategic emerging industry, advanced manufacturing industry and modern service industry. The government will guide SOEs become more professional, international and market-orientated during the reform. In addition, the government encourages SOEs

establish effective incentive system, improve the outdated and ragescent salary system so that to motive employees' internal innovation. For those competitive industries enterprises, the pay should adjust to "base+performance bonus+long-term incentives"; while for public utilities enterprises, besides the "base+performance bonus" salary, there will be particular bonus based on appraised assignment. To sum up, the government concentrates on better managing and allocating the enormous amount of state assets that exist in all of state enterprises, meanwhile, the government will release authority on supervising and interfering corporate daily operation in order to help SOEs build modern corporate system during the reform process, stimulate SOEs improving competitive and effective initially and reasonable for profits or losses in the market indecently rather than rely on governance subsidies, which is inappropriate in market economy.

**2. None of the SOEs which implemented mixed-ownership reform involved foreign capital as major shareholder through there were many famous and experienced investment institutions participating the biddings, so what is the government's attitude to allow foreign capital participating into the reform? It seems that foreign capital actually is prohibited so far.**

There is no prohibition or discrimination on foreign capital participating into SOE reform, the government's perspective on the current round of reform is to reduce administration interference and increase enterprises independent governance, obviously there will be no government provision for foreign capital institutions. Furthermore, what is the most needed thing for state enterprises right now? Absolutely is not money since it is easy for SOEs financing from banks due to their "state" reputation endorsement. Corporate governance is the first thing that SOEs confusing about. Board of shareholders, board of directors and management, how to allocate reasonably and manage scientifically on these three division? In deed they are illustrated clearly in every Article of

Association, whereas no one truly deal with these affairs properly especially during the transition process from traditional to modern corporate system. The seconded concern is management incentives, which is also the hardest one. Incentive system diversified based on different industries and enterprises, there are so many variables have to be considered. For example, it should be profits oriented, investment return oriented or market share oriented? The wrong performance examine standards might lead to disaster results. And strategy is the third concern, some state enterprises are in good condition now, however they worried about if wrong decisions are made in the future, such as a suddenly major merger or enormous investment, would drag the company to a terrible situation. Dealing with all of above confusing required deep and comprehensive understanding of the enterprise, and rich and effective experience as well, those fully-fledged foreign capital institutions are very welcomed to help Chinese SOEs on operation and development.

On the other hand, enterprises are also under the pressure from the public and media, if there are too many questions on projects sensibility from external, the corporates' decision definitely will be effected, hence in some sensitive industries foreign capital is not encouraged to enter.

Few foreign capital institutions won the bid because the enterprise would choose the ones that most match its situation requirement rather than just picked up some "big names" PE firms to impress the public. As the major shareholders of state enterprises, the private capital are supposed to help SOE fix operational problem and centralize resource for development, if they exist just as vaunting affairs but helpless, that is totally deviation from the original intension of mixed-ownership reform, thus there is no prejudice or discrimination on whether domestic or foreign capital, everything is considered from reality.

Although the government official attitude is equally treating domestic and foreign capital institutions, the reality reveals another view. Foreign capital like Goldman Sacks earned billions

dollars during state enterprises' sold equities first time ten years ago, in the current round of reform, the government seems to let domestic investment institutions take biggest piece of cake intentionally. When Sinopec sold its oil retail unit 17.5 billion dollars equities in 2014, foreign firms such as KKR and Ontario Teacher Pensions Plan participated the bid but all failed the competition. 96% of equities are sold to mainland and Hong Kong investment institutions. In August 2014, China Huarong Asset Management Company decided to involve strategic investors before it went public, only one foreign PE firm entered the finalist--Warburg Pincus LLC, which was attributed to the help of American Finance Minister.

These facts indicate that the governance might determine to complete the reform almost without foreign capital, SOE equities might be sold to domestic firms even at a lower price. According to a report published by Stanford C. Bernstein that Sinopec retail unit was sold 20% lower than the expectation price. The government had promised to encourage private firms to enter state enterprises monopolized industries such as oil and electricity, however it did not mean foreign capital is also encouraged. Sinopec claimed on the finalist announcement day that it would give preference to domestic institutions and those could "benefit the public" ones. In addition, another concern of the government is the possible conflicts between employees and foreign capital. As profits chasers, foreign PE firms might implement massive layoff plans through the reorganization, however a suddenly mess unemployment without pension and compensation would become a threat to the social stability, therefore, the government and SOEs both want to avoid from generating this kind of conflict.



## CHAPTER 5 CONCLUSION

This paper made a research on the current round state-owned enterprises reform using a typical SOE Greenland Group's reform as a case study. Now China is during the period of economy transition, and implementing state-owned enterprises reform is a necessary method to improve its economy transition smoothly. Most of previous studies focus on SOE reform happened ten years ago, while few scholars make researches on the current round of reform that started from last year. Moreover, this round of reform encourages private equity firms participating is new thoughts for China market, indicating fewer studies are related about this latest topic. This paper combines both the reform and PE's participating, researches on what kinds of effects that private equity can bring to SOEs during mixed-ownership reform, fills the gap of lacking studies on the current round of reform.

In order to research the topic, the author interviewed highly relevant officers in Greenland Group and Shanghai State-owned Assets Supervision and Administration Commission, research questions include the perspective of implementing this round of SOE reform, the effects of private equity on overall corporate governance and the concerns about foreign capital's participation in the reform. Based on the given answers, the author draw conclusions as below. The current round of state enterprises reform is a necessary move during China's economy transition. Updating and deepening the SOE reform contribute to releasing enterprises' vitality and increase competitiveness; traditional SOEs are expected to become more marketable, competitive and profitable through this reform; and the government hopes to complete state assets' smoothly exiting from SOEs during the mixed-ownership reform in order to encourage SOEs developing indecently and healthily.

As strategic investor, PE is expected to help SOE fix mismanagement problems during and after the mixed-ownership reform. Generally PE firms have rich experience and professional manager teams in dealing internal management problems, that the reason that most of state enterprises choose them rather than other investment institutions, and PE firms are supposed to help enterprises improve internal governance, build modern corporate system, optimize management incentive and salary

systems, furthermore, based on the current market condition, enterprises might cooperate with PE establishing industrial funds so that to improve industrial integration. In addition, the international recourses and advantages of PE firms also benefit SOEs on expanding overseas. At last, although the government's official attitude is very welcoming foreign capital participating into SOE reform, the facts reveal an opposite signal that domestic PE firms are more preferred than foreign ones. We have to admit that there are many concerns about foreign capital's participation, such as state asset loss, employment conflicts, more important, since state enterprises are usually centralized in national pillar and sensitive industries, the government might not allow foreign capital having great speaking rights in decision making process.

Three main limitations exist in this paper. The first limitation of this paper is limited literature reference. The current round of SOE reform has just begun since 2014, and with PE participation can be called an "innovation" in SOE reform history, therefore, there are enough academic researches can be directly referenced in this dissertation. Furthermore, state enterprises reform is a social problem with Chinese characteristic rather than a general worldwide topic, indicating that there are limited references for study this topic deeply.

In terms of research method, no data is collected for doing quantitative tests in this paper because the Greenland Group has not finished the listing process through the reverse merger transection had already completed, still as a private company, the Greenland Group did not publish annual reports or other financial figures to the public. In addition, quantitative tests of this kind of topic usually requires date for totally about fives years before and after the event happened, thus it is impossible to run any data regression in the current period.

At last, in the case study part, only interview method is used because observation and survey are not effective method in researching this case under the current condition, with a single research method might not confirm totally objective conclusions. Furthermore, answers of some research questions in

the interview with Greenland Group could not be provided due to information sensitivity, for example, “Were there any foreign private equity firms participate into the bidding when Greenland issued shared targeting non-state capital investors in 2013”, and this would effect the author research the case comprehensively.

Subsequent work might research the relevant topic through a quantitative method, collect qualified data when it is available, and run regression testing profitability, efficiency and other ratios to study the effects of PE during the reform. The development and impacts of “Listed company+PE” merger industrial funds might also be a further research topic suggested by the author.

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