Growing Moves in China to Restructure Companies and Foster New Industries

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I. Making Chinese industry more competitive one of the main aims of the 12th Five-Year Program

1. What is China's 12th Five-Year Program?

At the Fifth Plenum of the 17th CPC Central Party Committee, held from 15 to 18 October 2010, China's vice-president, Xi Jinping, was elected vice-chairman of the CPC's Central Military Commission. As such, he is likely to become China's next president at the 2012 Communist Party Conference.

On the economic front, the Plenum approved the Central Committee's *Proposal on Formulating the Twelfth Five-year Program* ("Proposal"), the full text of which was published on 27 October. Originally referred to as a five-year "plan," readers may not be familiar with the term "program." The old term has been replaced by the term "program" ever since the 11th Five-Year Program (2006–10).

The main reason for the change of term was that "program" was considered to mean a set of general guidelines, whereas "plan" was considered to strongly imply achieving a numerical target. In order to rectify the problems created by traditional five-year plans in their zeal to achieve numerical targets (e.g., overproduction, duplication of investment, and disparities), the 11th Five-Year Program sought to deal with some of the disparities that had arisen as a result of earlier plans (rather than simply pursue high economic growth and GDP targets), while reconsidering the government's role and making the most of market mechanisms.

The change of name also reflects the strong influence of the Hu-Wen government's "concept of scientific development" with its emphasis on the quality (rather than the quantity) of economic growth and on populist economic and social policies.

2. Outline of the Proposal

The main objective of the Proposal is how to increase the rate of change of China's economic development model in the five years from 2011. In order to achieve this, the Proposal aims (1) to strategically restructure the economy ("main battleground"), (2) to make technological progress and innovate ("main pillar"), (3) to ensure and

improve people's standard of living ("departure and arrival points"), (4) to conserve energy and protect the environment ("key objectives"), and (5) to reform and open up the economy ("powerful driving force").

The Proposal consists of 12 sections with a total of 56 subsections: (1) changing China's economic development model, (2) stimulating domestic demand, (3) developing agriculture and farming villages, (4) making China's industries more competitive, (5) increasing urbanization, (6) protecting the environment and conserving energy, (7) fostering science, education and training, (8) improving public services, (9) fostering China's cultural development, (10) reforming the economy, (11) opening up the economy, and (12) gaining universal support for the Proposal's aims. The aim of making China's industries more competitive marks a move away from relying on low-cost materials and labor in an attempt to change the status of Chinese manufacturing, restructure Chinese industry, and to make the country a technological superpower.

3. Making China's industries more competitive

The section on making China's industries more competitive comprises six policies: (1) restructuring Chinese manufacturing and raising its game, (2) fostering the development of strategic new industries, (3) increasing the rate of development of the service sector, (4) creating a modern energy industry and a better transport system, (5) improving information technology across the board, and (6) fostering the development of China's marine economy.

The policies of restructuring Chinese manufacturing and raising its game and fostering the development of strategic new industries involve not only restructuring the corporate sector and creating new industries but also ensuring that debt and equity markets, both in China and overseas, are able to meet the financial needs that will arise in the process of making China's industries more competitive (Figure 1).

In Chapter II we consider the government's policies to encourage corporate restructuring, while in Chapter III we consider its policies to foster the development of new industries. In Chapter IV we analyze the different types of manufacturing industry in China and their profitability, and see just how important strategic investment by both private-sector Chinese companies and foreign companies is. In Chapter V we take a closer look at moves to increase the enterprise value of central state-owned enterprises (i.e., those run by the central government). Finally, in Chapter VI, we examine the government's reassessment of the role foreign companies play in raising profitability and its new approach to reforming state-owned enterprises, and consider their implications for Japan.

Figure 1: Policies aimed at making Chinese industry more competitive

Objective	Policy document	Publication	Gist and key areas
Increase industrial competitiveness	*Proposal on Formulating the Twelfth Five-year Program*	10/27/2010	Restructuring and raising the level of Chinese manufacturing, and fostering and developing strategic new industries
Encourage corporate restructuring	*Opinions on Promoting Enterprise Mergers and Restructuring*	9/6/2010	Six sectors (automobiles, iron & steel, cement, plant & machinery, electrolytic aluminum, and rare earths) designated as key industries
Foster new industries	*Decision to Accelerate Nurturing and Developing Strategic Emerging Industries*	10/10/2010	Seven sectors (energy conservation and the environment; biotechnology; new materials; next-generation information technology; high-value-added equipment manufacturing; new types of energy; and alternative energy vehicles) designated as strategic new industries that need to be fostered
Attract private-sector capital	*Several Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment*	5/13/2010	Range of activities in which private-sector capital may be invested extended to the following six areas: basic industry and basic infrastructure; public works in urban areas and the construction of social housing; public welfare (healthcare, education, social welfare, and culture); financial services; commerce, trade and distribution; and defense-related science and technology
Attract foreign capital	*Several Opinions on Further Improving the Work of Foreign Capital Utilization*	4/6/2010	*Industrial Catalogue for Foreign Investment* revised (e.g., high added-value manufacturing, high-tech industries, alternative energy, and energy conservation and the environment)

Source: Nomura Institute of Capital Markets Research, based on State Council data

II. Government's policies to encourage corporate restructuring

1. 12th Five-Year Program's approach to corporate restructuring

The Proposal puts forward the following five policies for restructuring Chinese manufacturing and raising its game.

The first sees restructuring as the key to the future of Chinese manufacturing and emphasizes the need to improve both product quality and quantity, increase supply chain capacity, and weed out obsolete industries.

The second is to foster the development of advanced equipment manufacturing, restructure basic material production, restructure the production of consumer goods and raise its game, and raise the level of Chinese manufacturing in general.

The third is to raise the level of R&D and system integration in the fields of basic industrial technology, basic materials, and basic parts by means of key national projects intended to develop key technological equipment and policies.

The fourth is to help companies adopt new technology to enable them to develop new products and brands.

The fifth is to encourage companies to merge and restructure as efficiently as possible, to encourage consolidation within industries, to develop large and medium-sized companies with internationally well known brands and core competences, to enable small companies to specialize, and to encourage companies to find the most appropriate structure for them.

2. Approach to restructuring

1) Six sectors designated as key sectors for restructuring

Before the Fifth Plenum, China's State Council promulgated (on 28 August 2010) and published (on 6 September 2010) its *Opinions on Promoting Enterprise Mergers and Restructuring* ("the Opinions").

In its Opinions, the State Council designates six sectors (automobiles, iron & steel, cement, plant & machinery, electrolytic aluminum, and rare earths) as key sectors and announces policies to encourage the restructuring of Chinese companies and cross-border M&A, consolidation and economies of scale, the development of companies with their own intellectual property rights and brands, and the creation of large, competitive corporate groups.

The State Council points out that the Opinions are necessary because, although some success has been achieved in recent years (e.g., by means of mergers and the transfer of equity and assets), some industries still suffer from duplication of investment and serious shortcomings (e.g., insufficient consolidation, an inability to develop their own products, and a lack of competitiveness). It also points out that the situation is changing as Chinese companies face increasing constraints in terms of resources and the environment, increasingly fierce international competition, and the rise of protectionism.

2) Support for corporate restructuring

The Opinions advocate that, in order to encourage companies in the designated six sectors to restructure, institutional obstacles should be removed, fiscal and financial support should be provided, regulatory controls and administrative services should be improved, and regulatory agencies should play a more active role. The fiscal and financial support would take eight different forms: (1) preferential tax treatment, (2) fiscal expenditure, (3) financial support, (4) measures to encourage technological innovation, (5) the use of capital markets, (6) land management, (7) the resolution of disputes between creditors and debtors, and the relocation of workers, and (8) the reform of corporate governance. The Opinions make the following more detailed proposals for ways in which financial support and the use of capital markets could help companies to restructure.

(1) Financial support

The Opinions call for the following five forms of financial support to help companies merge and restructure.

First, commercial banks should be more positive about and take a longer-term view of lending for M&A. This would increase the amount of funds available and make them available for more reasonable periods.

Second, commercial banks should be encouraged to grant companies a general line of credit once they have been merged or restructured.

Third, securities companies, fund management companies, equity investment funds (including private equity funds), and industrial funds should be encouraged to become involved in mergers and restructurings, and to offer financial support to companies (e.g., in the form of direct investment, loans made via banks, and bridging loans).

Fourth, more should be done to develop new financing models for mergers and restructurings (e.g., special M&A funds) and to provide exits for equity investors.

Fifth, companies should be offered more support for cross-border M&A (e.g., in the form of M&A loans, domestic and international syndicated loans, and interest rate subsidies).

What is interesting about this is that the Opinions envisage the use of cross-border M&A and propose the use of funds and syndicated loans, both domestic and international, for this purpose.

(2) The use of capital markets

The Opinions call for the following three uses of capital markets to help companies merge and restructure.

First, the range of capital market mechanisms to enable companies to merge and restructure should be increased; the methods used to value companies should be improved; rules and policies should be devised; companies should be encouraged to use capital markets to merge and restructure; and industries should be restructured and modernized.

Second, eligible companies should be helped to raise the capital they need to merge and restructure by issuing equity and debt securities (e.g., shares, straight bonds, and convertible bonds).

Third, listed companies should be encouraged to use their equity and cash as means of payment when merging or restructuring, to use a greater range of funding options when merging or restructuring, and to restructure by using capital markets more effectively.

The significant point is that companies are encouraged to adopt new approaches to mergers and restructuring by using capital markets (e.g., equity swaps and better ways to value companies).

Figure 2: Division of responsibility for encouraging companies to merge and restructure

No.	Task	Department(s) in charge	Departments involved
1	Rewriting and removing regulations that make it difficult for companies to merge and restructure	MIIT	Governments of all provinces, autonomous regions, and municipalities directly under the central government
2	Attracting private-sector capital	MIIT	NDRC, MOLAR, State Administration for Industry & Commerce (SAIC), CBRC, etc.
3	Providing tax incentives	Ministry of Finance (MOF)	State Administration of Taxation (SAT)
4	Granting M&A loans, granting lines of credit following mergers and restructurings, assisting cross-border M&A	CBRC, PBC	NDRC, MIIT, MOF
5	Launching M&A funds, offering exit strategies, issuing shares, bonds and convertible bonds	CSRC, NDRC	MIIT, MOF
6	Establishing special funds within the budget for central government state capital operations	MOF	SASAC, NDRC, MIIT, MOFCOM
7	Establishing interest rate subsidies, loans, and special M&A funds at local government level	Governments of all provinces, autonomous regions, and municipalities directly under the central government	
8	Adopting market mechanisms for mergers and restructurings, using listed companies' shares and cash to raise capital	CSRC	NDRC, MOF, MOFCOM, PBC, CBRC
9	Granting preferential treatment in the use of land	Ministry of Land and Resources (MOLAR)	MOF
10	Upgrading technology, establishing technology centers, weeding out sunset industries, preventing irrational investment and duplication of investment	NDRC, MIIT	MOF
11	Restructuring debt and encouraging participation of institutional investors	MOF	NDRC, PBC, SASAC, CBRC
12	Hiving off non-core activities of state-owned enterprises, laying off unneeded workers	MOF, SASAC	MOHRSS
13	Devising employment policies and re-employing unemployed workers	MOHRSS, MOF, governments of all provinces, autonomous regions, and municipalities directly under the central government	SASAC
14	Constructing a public service platform for both domestic and overseas mergers and acquisitions	MIIT	NDRC, MOFCOM, CSRC
15	Offering advice (e.g., from securities companies) on cross-border mergers and acquisitions	MOFCOM	CBRC, CSRC, MIIT, NDRC, etc.
16	Complying with regulatory requirements	MIIT	NDRC, MOF, MOFCOM, SASAC, PBC, SAT, SAIC, CBRC, CSRC
17	Resolving and analyzing problems that arise when companies merge or restructure	MIIT	NDRC, MOF, MOHRSS, MOFCOM, PBC, SASAC, CBRC, CSRC
18	Ensuring that mergers and restructurings do not infringe China's Antimonopoly Law	MOFCOM	NDRC, MIIT, SASAC, etc.
19	Monitoring trading during important mergers and restructurings	MIIT	NDRC, MOF, MOFCOM, SASAC, CSRC
20	Apportioning responsibility among government departments	MIIT	NDRC, MOF, MOHRSS, MOLAR, MOFCOM, PBC, SASAC, SAT, SAIC, CBRC, CSRC, etc.

Source: Nomura Institute of Capital Markets Research, based on *Opinions on Promoting Enterprise Mergers and Restructuring*

3. Clarifying the role of the authorities involved

It is important to clarify the powers and responsibilities of the authorities chiefly responsible for considering policies such as these. That is why the Opinions stipulate the role of each of the government departments involved (Figure 2). More detailed rules for implementing each of the policies for encouraging companies to merge and restructure can be expected to emerge in the coming months.

III. Fostering new industries

1. Seven sectors designated as strategic new industries

The Proposal designates seven sectors as strategic new industries that need to be fostered: energy conservation and the environment; biotechnology; new materials; next-generation information technology; high-value-added equipment manufacturing; new types of energy; and alternative energy vehicles.

On 8 September 2010 the State Council examined and approved the *Decision to Accelerate Nurturing and Developing Strategic Emerging Industries* ("the Decision"). The Decision was promulgated on 10 October and published on 18 October.

The Decision describes the strategic new industries as major economic and social driving forces, and points out that other major economies have identified them as key industries to lead their economic and scientific/technological development.

2. Means and objectives of fostering new industries

1) Setting quantitative and qualitative objectives

The Decision sets both quantitative and qualitative objectives. First, its quantitative objectives. It sets the objective of raising the contribution of China's new strategic industries to GDP to 8% by 2015, the final year of the 12th Five-Year Program, and to 15% by 2020. Second, its qualitative objectives. It sets the objectives of having, by 2030, strategic new industries whose overall innovativeness and level of development are equal to the best in the world in order to be able to ensure continued economic and social development in China. The Decision also sets targets for each of the above seven sectors (Figure 3)[1].

2) Support for corporate restructuring

In order to foster the development of the seven designated sectors, the Decision proposes the following measures: increasing technological innovation; fostering the development of markets and creating favorable market conditions; improving international cooperation; providing fiscal and financial support; and reforming the administrative system. The fiscal and financial support would take the following five forms: (1) fiscal expenditure, (2) preferential tax treatment, (3) financial support, (4) the use of capital markets, and (5) the use of investment funds. Measures (3) – (5) (financial support; the use of capital markets; and the use of investment funds) contain the following more specific proposals.

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[1] On 18 August 2010, 16 central state-owned enterprises joined together under SASAC's guiding hand to form the Electric Vehicle Industry Alliance. The Chinese government plans to invest RMB100 billion over the next 10 years in assisting the development of a new-energy vehicle industry (Shanghai Securities News, 18 August 2010).

Figure 3: Seven strategic new industries and key areas

Strategic new industry	Key areas
Energy conservation and the environment	Energy conservation equipment, recycling equipment, environmental conservation equipment, energy and environmental conservation services, waste recovery and cyclic utilization, clean coal utilization, comprehensive utilization of seawater.
Biotechnology	Development of new drugs (such as biomedical pharmaceuticals, new vaccines, pharmaceuticals, and modern Chinese medicines) used in the prevention and control of serious illnesses. Research, development and industrialization of advanced medical equipment, medical materials and other biomedical engineering products. Development of new bio seeds, green development for agricultural use, development and application of core technologies for bio manufacturing, development and production of marine biology technology.
New basic materials	New types of functional materials such as rare earth functional materials, high-performance membrane materials, special glass, functional ceramics and semiconductor illumination materials. Advanced structural materials as high-quality special steel, new types of alloy materials and engineering plastics. High-performance fibers and their composites such as carbon fiber, aramid fiber and ultra-high molecular weight polyethylene (UHMWPE) fiber. Generic basic materials such as nanomaterials, superconductive materials, and intelligent materials.
Next-generation information technology	IT network infrastructure, next-generation mobile communications, next-generation network core devices and intelligent terminals, triple play integration, Internet of things, and cloud computing. Core basic industries such as integrated circuits, new types of LCD, high-end software, and high-performance servers. Software services, valued-added Internet services. Virtualization, creative and cultural industries.
High-value-added equipment manufacturing	Aerospace equipment such as general-purpose passenger aircraft and local route passenger aircraft. Satellite and satellite-related industries. Dedicated passenger railway lines and urban railway systems. Marine project equipment. Intelligent manufacturing equipment.
New types of energy	Nuclear power industry, solar energy, wind power, smart grid, bioenergy.
Alternative energy vehicles	Key and core technologies of power batteries, drive motors and electronic control systems. Plug-in hybrid vehicles, pure electric vehicles, low fuel consumption/energy-saving vehicles.

Source: Nomura Institute of Capital Markets Research, based on *Decision to Accelerate Nurturing and Developing Strategic Emerging Industries*

(1) Financial support

Financial support to foster the development of new industries would take the following five forms.

First, financial institutions would be encouraged to establish credit controls and due diligence procedures that accorded with the characteristics of the strategic new industries.

Second, they would be encouraged to use innovatory forms of finance such as supply chain loans and loans backed by intellectual property rights.

Third, the process of creating a multi-tier system of security and guarantees, involving both government and private-sector finance, would be speeded up.

Fourth, greater efforts would be made to establish mid-tier financial institutions and new types of financial services.

Fifth, widespread use would be made of preferential fiscal treatment to mitigate risk, and financial institutions would provide more support to strategic new industries.

Much will depend on the extent to which financial institutions can provide services that meet the needs of new industries. What is distinctive about these proposals is that

they involve not only training the necessary staff and acquiring the necessary know-how but also the use of government money in one form or another to mitigate or eliminate lending risk.

(2) The use of capital markets

The use of capital markets to foster the development of new industries would take the following four forms.

First, the Second Board system (for start-ups) would be extended to enable companies that meet the requirements to list.

Second, the OTC market system would be extended to enable companies at different stages of development to meet their financing needs.

Third, a mechanism to allow companies to move between markets at different tiers would enable these markets gradually to be linked.

Fourth, China's bond market should develop to allow greater issuance of joint bonds and joint medium-term notes by small and medium enterprises; active consideration should be given to developing products such as high-yielding bonds and privately placed convertible bonds; the development of enterprise bonds, corporate bonds, commercial paper, and medium-term notes should be gradually stepped up; and there should be a greater variety of debt-financing options.

What is noteworthy about these proposals is that they strongly advocate not only the use of the Second Board and OTC market systems but also the issue of joint bonds and high-yielding bonds by small and medium enterprises.

(3) Use of investment funds

The use of investment funds to foster the development of new industries would take the following four forms.

First, in order to encourage investment in innovation and foster the healthy development of equity investment, the necessary policy framework and regulatory system need to be established.

Second, as far as risk controls allow, the conditions should be created for insurance companies, the National Social Security Fund, occupational pension schemes and other institutional investors to invest in these new industries (i.e., in innovation and equity investment funds).

Third, the government should assume responsibility for directing funds for innovation investment to these new industries; this investment should be increased; and private-sector funds should be directed especially to companies in these sectors that are either start-ups or have not been established for very long, making full use of market mechanisms.

Fourth, private-sector capital should be encouraged to invest in these strategic new industries.

What is noteworthy about these proposals is that they encourage institutional investors such as pension funds and insurance companies to invest in these industries in the awareness that the publicity surrounding the government's commitment to these industries will itself have a positive impact.

IV. Distribution and profitability of Chinese industrial enterprises

1. Definition of "industrial enterprise"

In this section we analyze the profitability of Chinese industrial enterprises in the public and private sectors as well as that of foreign-invested enterprises. Before that, however, we need to define what the term "industrial enterprise" means in China.

When companies are officially registered in China, it is as one of three main types of business entity: "domestic enterprises," "enterprises formed by investors from Hong Kong, Macau or Taiwan," and "foreign-invested enterprises." Domestic enterprises may be state-owned enterprises, collectively owned enterprises, stock cooperative enterprises (the shares of which are jointly owned by the workers), jointly operated enterprises (the shares of which are owned by at least two legal persons), limited liability companies (with 1–50 shareholders), companies limited by shares (or joint stock companies), private enterprises (formed and run by natural persons) or "others."

As, in the case of state-owned enterprises operating in the industrial field, jointly operated state-owned enterprises are included in the statistics for jointly operated enterprises and wholly state-owned limited liability companies are included in those for limited liability companies, our analysis needs to include them in the statistics for enterprises registered as state-owned enterprises in the narrow sense of the term. Similarly, since the state-owned economy is included in companies limited by shares from the point of view of ownership but cannot be separated from the statistics for the non-state sector, we have included it in "others."

2. Distribution of industrial enterprises (in 2009)

We now consider the distribution of state-owned enterprises, private enterprises, enterprises formed by investors from Hong Kong, Macau or Taiwan, foreign-invested enterprises, and "others" on the basis of the principal economic indicators for industrial enterprises above a certain size (annual sales of RMB5 million) in the *China Statistical Yearbook*. We can see from these data that private enterprises and foreign-invested enterprises already constitute the majority of industrial enterprises in terms of both size and number.

Figure 4: Key data for Chinese industrial enterprises above a certain size

	Number of companies	Added industrial value (RMB100mn)	Assets (RMB100mn)	Operating revenue (RMB100mn)	Total profit (RMB100mn)	Number of employees (10,000s)
State-owned enterprises	9,105	45,648	68,685	47,035	1,973	639
Private enterprises	256,031	162,026	91,176	156,604	9,678	2,974
Enterprises formed by investors from Hong Kong, Macau or Taiwan	34,365	52,221	44,514	51,130	3,448	1,143
Foreign-invested enterprises	41,011	100,466	79,963	99,133	6,659	1,307
Other	18,651	16,664	10,641	16,263	1,067	326
Total	359,163	377,025	294,979	370,165	22,825	6,390

Note: 1. "Above a certain size" here means an industrial enterprise with annual sales of at least RMB5 million.
2. "State-owned enterprises" includes jointly operated state-owned enterprises and wholly state-owned limited liability companies.
3. "Other" includes collectively owned enterprises, stock cooperative enterprises, and jointly operated enterprises.

Source: Nomura Institute of Capital Markets Research, based on *China Statistical Yearbook*

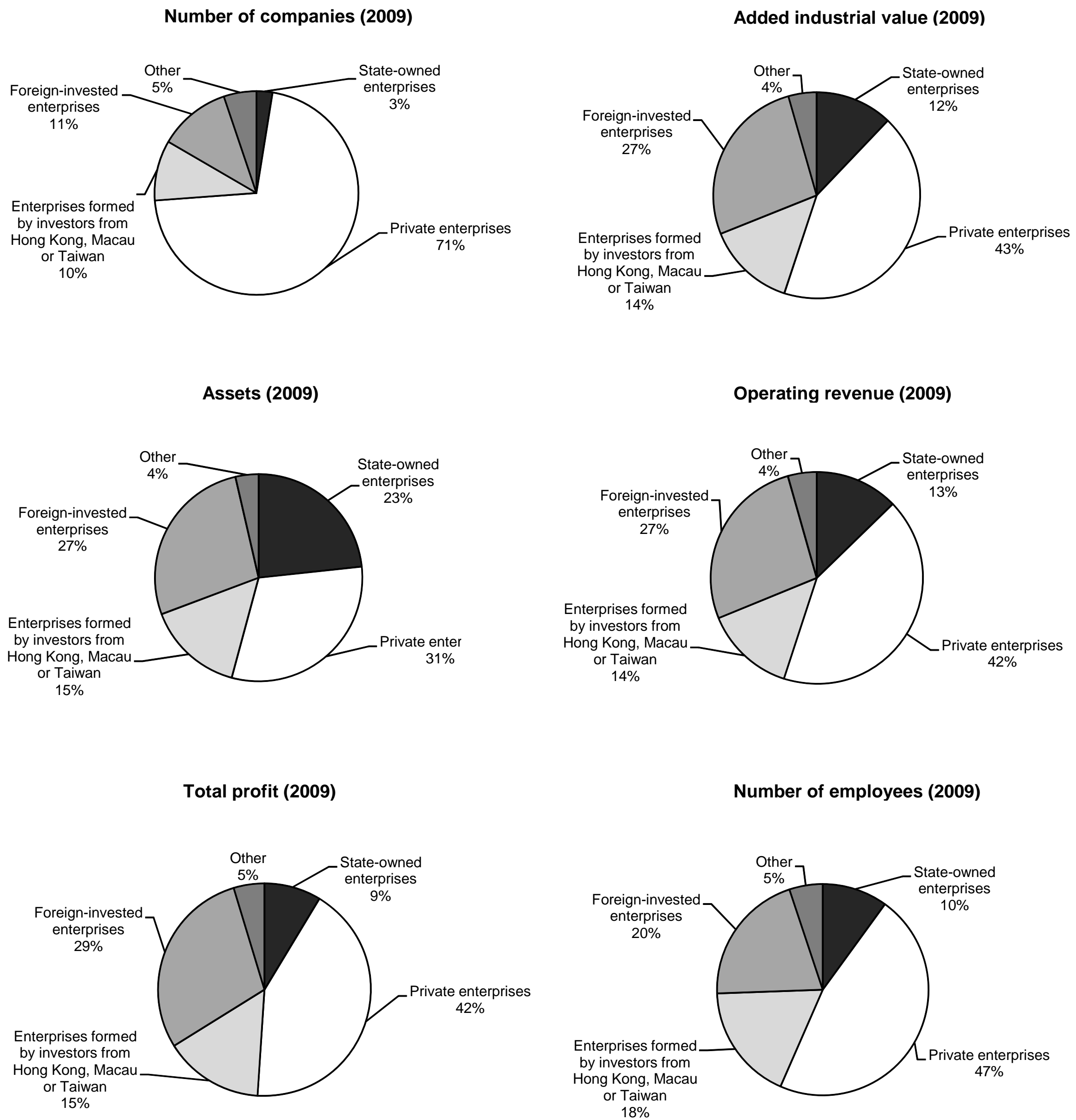
1) Number of companies

Whereas there are only 9,105 state-owned enterprises, there are (in descending order) 256,031 private enterprises, 41,011 foreign-invested enterprises, and 34,365 enterprises formed by investors from Hong Kong, Macau or Taiwan (Figure 4). In percentage terms, state-owned enterprises account for only 3% of all Chinese companies, while private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan account for 71%, 11%, and 10%, respectively (Figure 5).

2) Added industrial value

Whereas state-owned enterprises generate RMB4,564.8 billion of added industrial value, private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan generate RMB16,202.6 billion, RMB10,046.6 billion, and RMB5,222.1 billion, respectively (Figure 4). In percentage terms, state-owned enterprises account for 12% of total added industrial value, while private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan account for 43%, 27%, and 14%, respectively (Figure 5).

Figure 5: Breakdown of key data for Chinese industrial enterprises above a certain size



Note:
1. "Above a certain size" here means an industrial enterprise with annual sales of at least RMB5 million.
2. "State-owned enterprises" includes jointly operated state-owned enterprises and wholly state-owned limited liability companies.
3. "Other" includes collectively owned enterprises, stock cooperative enterprises, and jointly operated enterprises.

Source: Nomura Institute of Capital Markets Research, based on *China Statistical Yearbook*

3) Assets

Whereas state-owned enterprises have assets worth RMB6,868.5 billion, private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan have assets worth RMB9,117.6 billion, RMB7,996.3 billion, and RMB4,451.4 billion, respectively (Figure 4). In percentage terms, state-owned enterprises' assets account for 23% of the total, while those of private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan account for 31%, 27%, and 15%, respectively (Figure 5).

4) Operating revenue

Whereas state-owned enterprises generate RMB4,703.5 billion of operating revenue, private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan generate RMB15,660.4 billion, RMB9,913.3 billion, and RMB5,113.0 billion of operating revenue, respectively (Figure 4). In percentage terms, state-owned enterprises generate 13% of total operating revenue, while private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan generate 42%, 27%, and 14%, respectively (Figure 5).

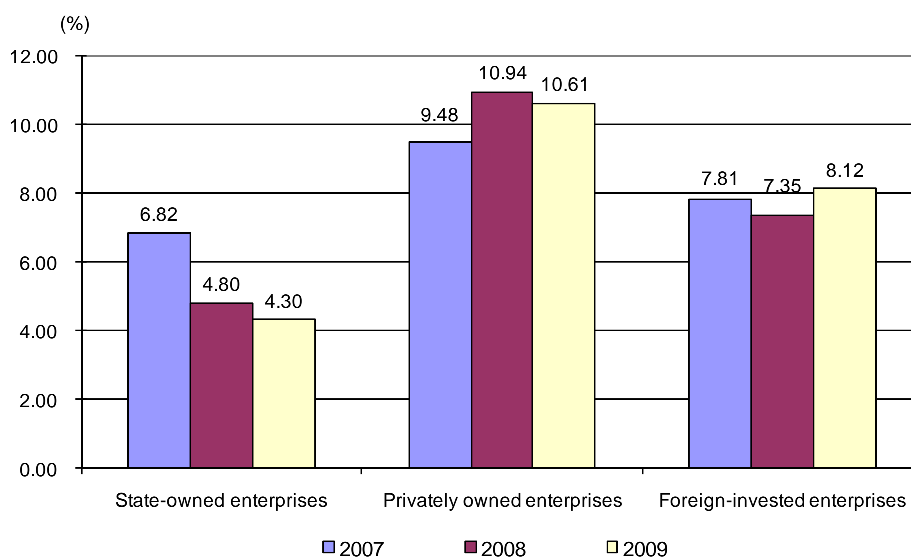
5) Total profit

Whereas state-owned enterprises generate RMB197.3 billion of total profit, private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan generate RMB967.8 billion, RMB665.9 billion, and RMB344.8 billion of total profit, respectively (Figure 4). In percentage terms, state-owned enterprises generate 9% of total profit, while private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan generate 42%, 29%, and 15%, respectively (Figure 5).

6) Number of employees

Whereas state-owned enterprises employ 6.39 million people, private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan employ 29.74 million, 13.07 million, and 11.43 million people, respectively (Figure 4). In percentage terms, state-owned enterprises employ 10% of China's working population, while private enterprises, foreign-invested enterprises, and enterprises formed by investors from Hong Kong, Macau or Taiwan employ 47%, 20%, and 18%, respectively (Figure 5).

Figure 6: Return on assets (all-sector average)



Note: Return on assets has been derived by dividing the total profit of each type of company by its total assets.

Source: Nomura Institute of Capital Markets Research, based on *China Statistical Yearbook*

3. Comparison of profitability of China's industrial enterprises (in 2007–09)

We now compare the profitability of state-owned enterprises, private enterprises, and foreign-invested enterprises on the basis of the principal economic indicators for industrial enterprises above a certain size (annual sales of RMB5 million) in the *China Statistical Yearbook*. More specifically, we compare their return on assets, return on equity, and ratio of profits, taxes and interest to average assets for 2007–09 (i.e., the three-year period straddling the financial crisis).

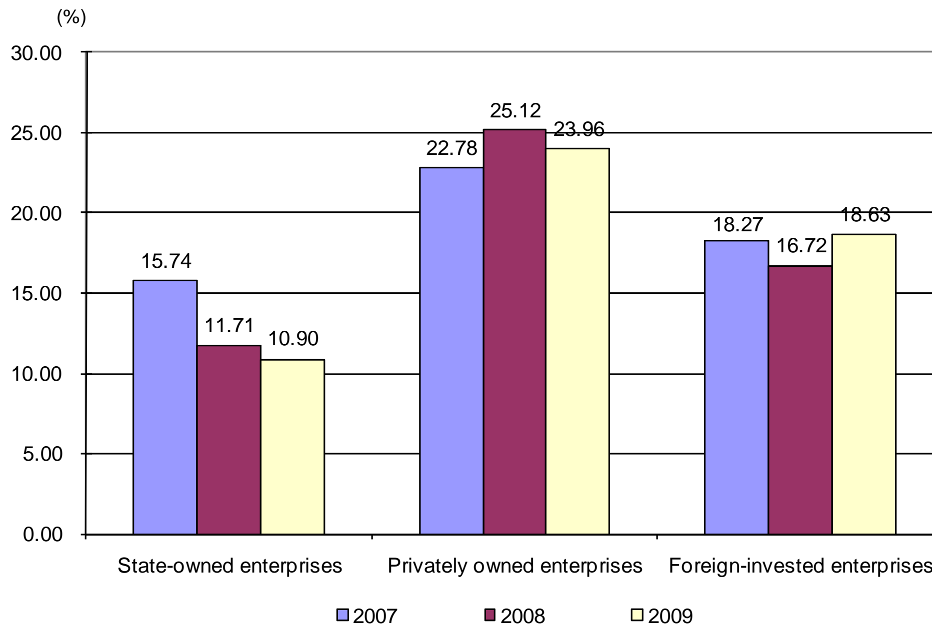
1) Return on assets

Return on assets (ROA) is a general indicator of profitability, showing how efficiently a company's total assets have been used to generate profit. In this report, for the sake of convenience, we have calculated this using the formula total profit/total assets.

What we found is that the ROA of state-owned enterprises declined from its 2007 level of 6.82% to 4.80% in 2008, when the global financial crisis worsened, and to 4.30% in 2009 (Figure 6).

In contrast, the ROA of private enterprises rose slightly from its 2007 level of 9.48% to 10.94% in 2008 but declined slightly to 10.61% in 2009. According to a spokesperson for the Development Research Center of the State Council, the reason the ROA of private enterprises rose in 2008, when the global financial crisis worsened,

Figure 7: Return on equity (all-sector average)



Note: Return on equity has been derived by dividing the total profit of each type of company by its owners' equity.
Source: Nomura Institute of Capital Markets Research, based on *China Statistical Yearbook*

was probably that financial restructuring and cost cutting took effect[2]. Similarly, the ROA of foreign-invested enterprises declined slightly from its 2007 level of 7.81% to 7.35% in 2008 but recovered to 8.12% in 2009.

We can see from these findings that the ROA of private enterprises and foreign-invested enterprises is generally higher than that of state-owned enterprises and that state-owned enterprises were still suffering the effects of the global financial crisis in 2009.

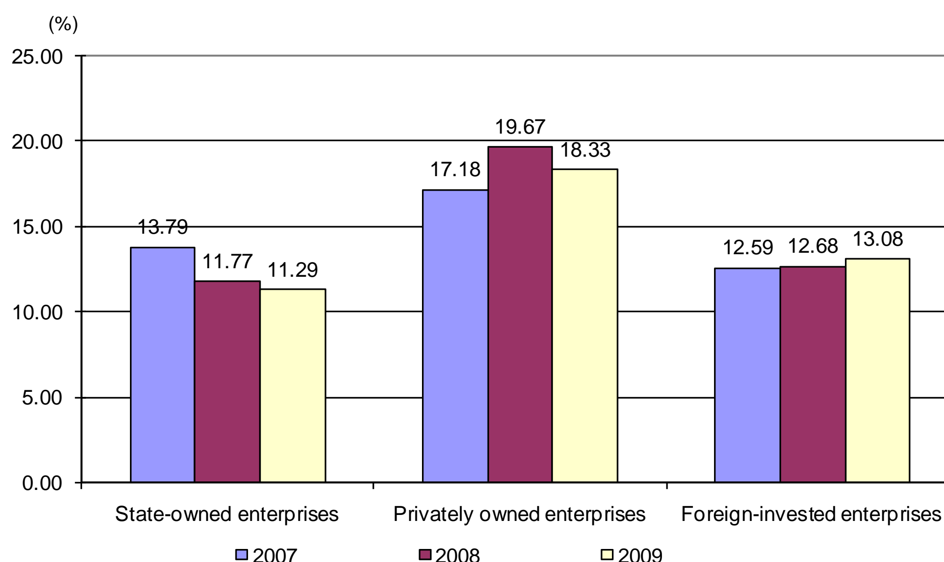
2) Return on equity

Return on equity (ROE), the ratio of a company's net profit to its owners' equity, is an indicator of the extent to which a company's management is fulfilling its obligations to the company's shareholders. In this report, for the sake of convenience, we have calculated this using the formula total profit/owners' equity.

What we found is that, as with ROA, the ROE of state-owned enterprises declined from its 2007 level of 15.74% to 11.71% in 2008, when the global financial crisis worsened, and to 10.90% in 2009 (Figure 7).

2 Particularly with regard to cost-cutting, the spokesperson thought that the reduction in employment costs as a result of the loss of some 10 million jobs for migrant agricultural workers in 2008 and the reduction in inventories as a result of the closure of factories (especially private-sector factories) in the north of China because of the Olympics the same year had enabled such enterprises to avoid losses caused by higher material costs.

Figure 8: Ratio of profits, taxes and interest to average assets (all-sector average)



Note: Ratio has been derived by dividing the total profit, total taxes, and interest payments of each type of company by its average total assets.

Source: Nomura Institute of Capital Markets Research, based on *China Statistical Yearbook*

In contrast and as with ROA, the ROE of private enterprises rose from its 2007 level of 22.78% to 25.12% in 2008 but declined slightly to 23.96% in 2009. Similarly, the ROE of foreign-invested enterprises declined slightly from its 2007 level of 18.27% to 16.72% in 2008 but recovered to 18.63% in 2009.

We can see from these findings that the ROE of private enterprises and foreign-invested enterprises is also generally higher than that of state-owned enterprises. Also, as with ROA, the reason the ROE of private enterprises rose in 2008, when the global financial crisis worsened, may have been that financial restructuring and cost cutting took effect.

3) Ratio of profits, taxes and interest to average assets

The ratio of profits, taxes and interest to average assets shows a company's ability to obtain a return on its total assets and is derived by dividing the sum of its total profit, total taxes, and interest payments by its average total assets for the period concerned. The ratio is already calculated in the *China Statistical Yearbook*.

What we found is that the ratio for state-owned enterprises declined from its 2007 level of 13.79% to 11.77% in 2008, when the global financial crisis worsened, and to 11.29% in 2009 (Figure 8).

In contrast and as with the two other ratios, the ratio for private enterprises rose from its 2007 level of 17.18% to 19.67% in 2008 but declined slightly to 18.33% in

Figure 9: Sector-by-sector comparison of key profitability ratios

Sector	ROA			ROE			Ratio of profits, taxes and interest to average assets		
	State-owned enterprises	Privately owned enterprises	Foreign-invested enterprises	State-owned enterprises	Privately owned enterprises	Foreign-invested enterprises	State-owned enterprises	Privately owned enterprises	Foreign-invested enterprises
Overall	**4.30**	**10.61**	**8.12**	**10.90**	**23.96**	**18.63**	**11.29**	**18.33**	**13.08**
Coal extraction/cleaning /dressing	6.83	18.39	15.33	17.50	36.79	40.97	13.66	32.46	21.19
Extraction of oil and natural gas	12.57	16.44	44.58	22.95	23.53	271.55	18.43	23.72	51.77
Processing of agricultural by-products as food	4.79	14.67	8.85	12.73	27.65	22.75	9.41	23.38	13.58
Textiles	0.69	8.24	5.31	1.83	20.38	10.76	4.12	15.11	9.37
Clothing/footwear /headgear	5.31	11.12	9.57	16.45	24.41	18.94	8.17	19.58	15.18
Production of pharmaceuticals	8.20	10.40	12.87	15.67	20.93	23.21	13.53	17.72	19.67
Iron smelting/rolling	1.06	8.89	4.57	2.84	25.16	13.26	5.01	15.65	8.82
Production of transport equipment	6.52	8.42	12.15	18.76	22.64	31.28	12.62	14.63	20.91
Production of telecommunications equipment/computers/other electronic equipment	**2.81**	8.48	5.40	6.22	19.30	13.39	4.93	13.72	7.37

Note: Shading marks those sectors where privately owned and foreign-invested enterprises are more profitable than state-owned enterprises.
Source: Nomura Institute of Capital Markets Research, based on *China Statistical Yearbook*

2009. Similarly, the ratio for foreign-invested enterprises rose slightly from its 2007 level of 12.59% to 12.68% in 2008 and recovered to 13.08% in 2009.

We can see from these findings that the ratio of profits, taxes and interest to average assets for private enterprises and foreign-invested enterprises is also generally higher than that of state-owned enterprises. The reason the ratio for private enterprises rose in 2008, when the global financial crisis worsened, may have been that financial restructuring and cost cutting took effect.

4) Sector comparison (2009)

A sector-by-sector comparison of ROA, ROE and the ratio of profits, taxes and interest to average assets in 2009 (Figure 9) shows that private enterprises in the following sectors obtained high returns: coal extraction/cleaning/dressing, processing of agricultural by-products as food, textiles, clothing/footwear/headgear, iron

smelting/rolling ("iron industry"), and the production of telecommunications equipment/computers/other electronic equipment (e.g., mobile telephones)[3].

Similarly, foreign-invested enterprises in the following sectors obtained high returns: extraction of oil and natural gas, production of pharmaceuticals, and the production of transport equipment (vehicles, including two-wheel vehicles). The situation is much as one would expect as a result of the establishment of operations in China by foreign pharmaceutical and auto companies.

V. Establishing the equivalent of a China Investment Corporation for industry

1. Establishment of China Reform Holdings Corporation

The Chinese government has been considering setting up sovereign wealth funds modeled on similar funds in Singapore (e.g., Temasek and GIC) in order to increase the competitiveness of central state-owned enterprises. Also, as we have mentioned, it has proposed in its 12th Five-Year Program policies aimed at increasing the competitiveness of Chinese industry as part of its efforts to change China's economic development model.

As a result, on 22 December 2010, China's State-owned Assets Supervision and Administration Commission (of the State Council) (SASAC) held a general meeting to mark the establishment of China Reform Holdings Corporation and the Chinese government's intention to increase the value of the central state-owned enterprises for which it is responsible.

In reports in the mainland Chinese press the new company is sometimes referred to as "the industrial equivalent of China Investment Corporation" (the institution established in September 2007 to diversify the way in which China's foreign exchange reserves are invested and to achieve a higher return on these investments) or "CIC Mark II."

2. Brief description of China Reform Holdings

According to SASAC, Xie Qihua, former chairwoman of Baosteel Group Corporation, has been appointed chairwoman of China Reform Holdings with a registered capital of RMB4.5 billion, while Liu Dongsheng, former chairman of SASAC's board of supervisors (a vice-minister level position), has been appointed president. The role and position of the new company, the types of company it will be

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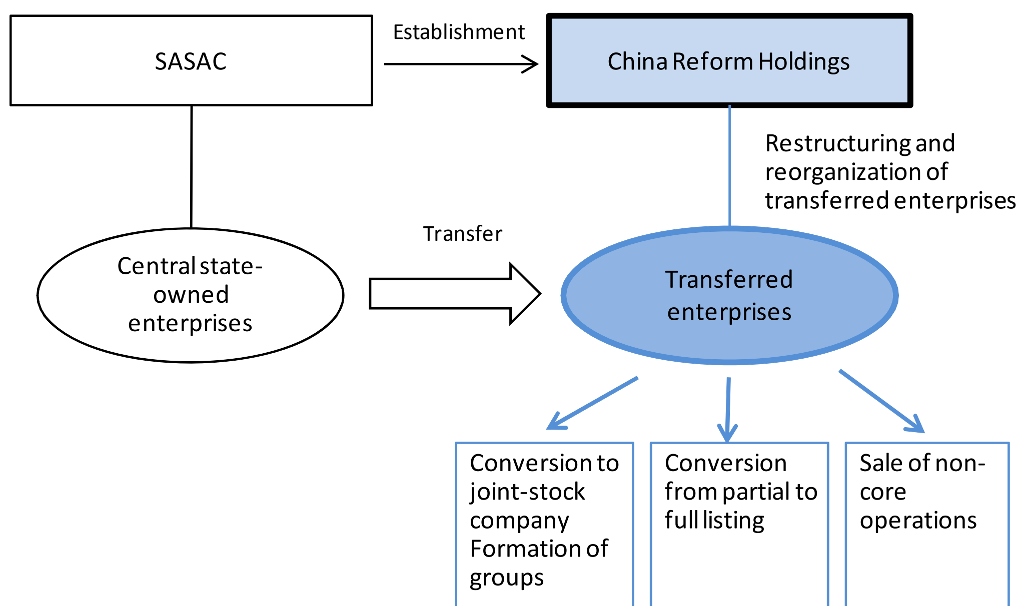
[3] However, there is also the question to what extent private enterprises shoulder the cost of complying with and maintaining environmental standards.

Figure 10: Schematic diagram of establishment and operation of China Reform Holdings



Source: Nomura Institute of Capital Markets Research, based on SASAC

responsible for managing, and the kinds of operation it will support are as follows (Figure 10).

1) New company's role

First, the new company will own and manage the assets of the central state-owned enterprises transferred from SASAC, and will share the responsibility for restructuring these companies.

Second, once the central state-owned enterprises as a whole have been listed, it will confiscate and restructure non-core assets and the assets that are left over in order to increase the competitiveness of the central state-owned enterprises' core operations.

2) Position of new company

It is clear from the new company's role that the new company is no different from other central state-owned enterprises in that it will operate as a business concern.

Second, the new company has a special role: namely, of restructuring central state-owned enterprises and their assets.

Third, the new company will manage assets rather than engage in production or investment.

3) Types of company China Reform Holdings will manage

It is envisaged that SASAC will transfer three types of company for management by China Reform Holdings.

The first is companies that are small and weak, and that do not belong to a sector that is critical for either China's national security or its economy.

The second is companies with relatively few connections with the operations of other large central state-owned enterprises and which stand to gain little from the restructuring of these enterprises.

The third is companies with a particular (e.g., public welfare) role that makes it inappropriate for them to become involved with companies in other sectors.

4) Kinds of operation China Reform Holdings will support

Once the management of a company has been transferred to it, China Reform Holdings is responsible for converting it to a joint stock company and restructuring its assets.

The first type of operation is where China Reform Holdings injects capital into and then (after restructuring) lists companies with the potential to compete and that operate in sectors government industrial policy is seeking to foster.

The second type is where China Reform Holdings supports the operations of companies with the potential to be restructured and to provide services related to strategic new industries.

The third type is where China Reform Holdings bears the cost of restructuring companies that have lost their ability to grow and recommends that the state withdraws its capital while safeguarding the rights of their employees.

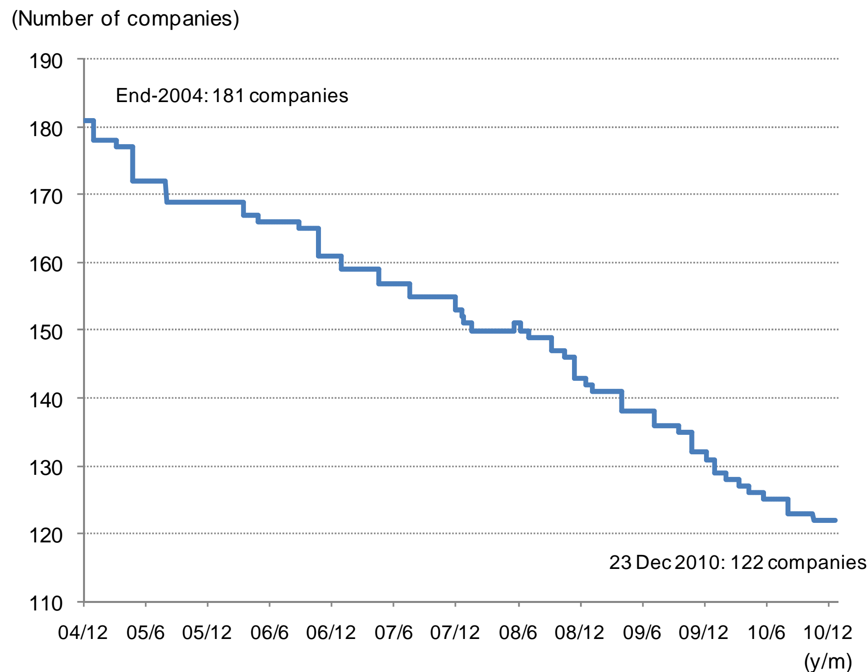
3. China Reform Holdings' future

SASAC has had considerable success in recent years in reducing the number of central state-owned enterprises it manages. From 181 at the end of 2004 the number has declined to 122 (as of 23 December 2010) (Figure 11) and is expected to decline further to about 100. In this connection, we have noted considerable interest among those involved with China Reform Holdings in how it is going to restructure the companies whose management has been transferred to it.

In restructuring central state-owned enterprises, it needs to ensure that its own governance is adequate and that it has staff with the necessary expertise. We therefore expect it to further cement its links with the Singaporean sovereign wealth funds on which it has modeled itself.

Japan's Industrial Revitalization Corporation (established in April 2003 and disbanded in March 2007) had experience with corporate turnarounds. China Reform

Figure 11: Number of central state-owned enterprises reporting to SASAC



Source: Nomura Institute of Capital Markets Research, based on SASAC

Holdings can also draw on the experience of the Innovation Network Corporation of Japan (INCJ), established in July 2009 to create new industries that cut across traditional business boundaries.

As more details are announced of China Reform Holdings' organizational structure and the companies it will have to manage, we will begin to have a clearer picture of its overall operations.

VI. Further efforts to increase the competitiveness of Chinese industry

1. Greater use of private-sector capital

As we saw in Chapter IV when we compared the profitability of different types of companies, Chinese private-sector capital and foreign capital remain key to fostering the development of new industries and restructuring Chinese companies in order to achieve the 12th Five-Year Program's objective of increasing the competitiveness of Chinese industry.

With regard to the use of private-sector capital, China's State Council published on 13 May 2010 *Several Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment*. These are a revision of the *Opinions of*

the State Council on Encouraging, Supporting and Guiding the Development of Individual and Private Economy and Other Non-Public Sectors of the Economy published five years earlier in February 2005. As both the earlier and the more recent *Opinions* consist of 36 articles, the more recent document is sometimes referred to as "*The New 36 Opinions*." In the *New 36 Opinions* the government extends the range of activities in which it will allow private-sector capital to be invested to the following six areas: (1) basic industry and basic infrastructure; (2) public works in urban areas and the construction of social housing; (3) public welfare (healthcare, education, social welfare, and culture); (4) financial services; (5) commerce, trade and distribution; and (6) defense-related science and technology. In addition, it encourages the private sector to invest in reforming state-owned enterprises.

Subsequently, on 26 July 2010, clarification of how this should be implemented was issued in the form of the *Notice of the State Council General Office on the Division of Key Tasks for Encouraging and Guiding the Healthy Development of Private Investment*. According to this, local (provincial) governments are to be responsible for coordinating the restructuring of state-owned enterprises when this involves several regions, while SASAC, the Ministry of Human Resources and Social Security (MOHRSS), and the China Banking Regulatory Commission (CBRC) are to be responsible when this involves, for example, the use of private-sector capital to acquire a stake, a controlling interest, or assets in a state-owned enterprise.

2. New process for reviewing use of foreign capital

On 6 April 2010 the State Council promulgated *Several Opinions on Further Improving the Work of Foreign Capital Utilization*. These contained a number of key new policies: selecting foreign capital on the basis of industrial policy; attracting foreign capital to China's central and western regions; and devolving to local governments the power to approve the use of foreign capital.

In particular, (1) foreign companies are encouraged to acquire equity stakes in and merge with domestic Chinese companies in order to reorganize and restructure them; (2) A-share companies are encouraged to find strategic investors, whether overseas or Chinese; and (3) foreign companies will be allowed to acquire Chinese companies and engage in inward portfolio investment. In order to make it easier for foreign companies to become involved in restructuring Chinese companies, the State Council published on 18 August 2010 a follow-up to its *Several Opinions on Further Improving the Work of Foreign Capital Utilization*. In it the Ministry of Commerce (MOFCOM) is given overall responsibility for devising policies and enacting legislation but is to be assisted by the China Securities Regulatory Commission (CSRC), the National Development and Reform Commission (NDRC), and the Ministry of Industry and Information Technology (MIIT) (Figure 12).

In this connection it is perhaps worth mentioning that we now see the possibility that central state-owned enterprises, which until now have only had the option of a partial listing that involved disposing of some of their assets when China Reform Holdings restructured companies and assets, will now have the option of a full listing.

Figure 12: Division of main responsibilities for implementing *Several Opinions on Further Improving the Work of Foreign Capital Utilization*

Objective	Tasks	Department in charge	Departments involved
1. Optimizing the structure of utilization of foreign investment	Revise *Industrial Catalogue for Foreign Investment* (e.g., high added-value manufacturing, high-tech industries, alternative energy, and energy conservation and the environment)	NDRC	MOFCOM
	Give foreign investment projects priority access to land	MOLAR	-
	Encourage foreign-invested enterprises and local companies to cooperate in R&D	NDRC	Ministry of Science and Technology (MOST), MOF
	Encourage foreign-invested enterprises to establish regional headquarters	MOFCOM	SAFE, CBRC, NDRC, MOF, SAIC
2. Guiding foreign investment to central and western regions, and to increase investment	Revise *Catalogue of Priority Industries for Foreign Investment in the Central-Western Region*	NDRC	MOFCOM
	Provide tax incentives to invest in the Central-Western Region	MOF	NDRC, MOFCOM, SAT
	Encourage foreign banks to establish branches in the Central-Western Region	CBRC	-
3. Promoting the diversification of utilizing foreign investment	Encourage foreign investors to participate in the reform, consolidation and reorganization of domestic enterprises	MOFCOM	CSRC, NDRC, MIIT
	Attract domestic and overseas strategic investors in A-share listed companies		
	Regulate participation in domestic securities investments and acquisitions of domestic enterprises		
	Encourage qualified enterprises to utilize overseas capital markets by listing abroad	CSRC	NDRC, MOFCOM
	Encourage foreign investors to establish bonding companies for small and medium enterprises	NDRC	MOFCOM
	Establish venture capital and private equity funds	NDRC	MOFCOM, SAIC, CSRC, SAFE
	Enable qualified foreign-invested enterprises to publicly offer shares and issue enterprise bonds and medium-term notes	PBC	CSRC, CBRC, NDRC, MOFCOM
	Expand scope of overseas entities eligible to issue RMB bonds in China		
4. Deepening the reforms in foreign investment management system	Delegate project examination and approval to local governments	NDRC	-
	Simplify the procedures and minimize the scope of examination and approval, etc.	MOFCOM	NDRC
5. Creating a favorable investment environment	Standardize and promote the development of development zones, etc.	NDRC	MOLAR, Ministry of Housing and Urban-Rural Development (MOHURD), MOST, MOFCOM
	Improve the foreign exchange management of foreign enterprises and simplify the procedures for foreign enterprises to convert foreign exchange into share capital	SAFE	-
	Allow foreign enterprises unable to make financial contributions in time an extension of contribution deadlines	SAIC	MOFCOM

Source: Nomura Institute of Capital Markets Research, based on *Several Opinions on Further Improving the Work of Foreign Capital Utilization*

In the case of partial listings, we envisage cases where private-sector Chinese capital or foreign companies bid for companies or assets, while, in the case of full listings on overseas stock markets, including Hong Kong, we envisage cases where foreign investors are involved. Although no list has been published thus far of the companies that are due to be transferred to the management of China Reform Holdings, it has

Figure 13: Geographical breakdown of foreign direct investment in China

2009				2010			
Rank	Country /region	Actual amount		Rank	Country /region	Actual amount	
		$mn	Share (%)			$mn	Share (%)
1	Hong Kong	53,993	60.0	1	Hong Kong	67,474	63.8
2	Taiwan	6,563	7.3	2	Taiwan	6,701	6.3
3	Japan	4,117	4.6	3	Singapore	5,657	5.3
4	Singapore	3,886	4.3	4	Japan	4,242	4.0
5	US	3,576	4.0	5	US	4,052	3.8
6	Korea	2,703	3.0	6	Korea	2,693	2.5
7	UK	1,469	1.6	7	UK	1,642	1.6
8	Germany	1,227	1.4	8	France	1,239	1.2
9	Macau	1,000	1.1	9	Netherlands	952	0.9
10	Canada	959	1.1	10	Germany	933	0.9
(cf.)	EU	5,952	6.6	(cf.)	EU	6,589	6.2
	Whole world	90,033	100.0		Whole world	105,740	100.0

Note: 1. Ranking is by the actual amount invested.
2. Foreign direct investment from Hong Kong and tax havens includes "round tripping."
3. The EU has 27 member nations.

Source: Nomura Institute of Capital Markets Research, based on MOFCOM

been reported in the local media that China Minmetals Corporation (CMC), a metal and mineral trading company, will be one of them[4].

3. Lessons for Japan

1) New opportunity for direct investment in China

The Chinese authorities are counting on foreign strategic investors as well as private-sector Chinese capital to achieve this restructuring of Chinese companies, fostering of new industries, and restructuring of central state-owned enterprises. What this means is that Japanese companies will also have new opportunities for direct investment in China. We think the combination of Japanese technological know-how and the Chinese market offers Japan the opportunity to benefit further from China's economic growth.

However, Japanese companies also have something to offer China. We can see from a geographical breakdown of inward direct investment in China in 2009 that, with the exception of Greater China and some tax heavens, Japan was the largest direct investor, with $4.1 billion (Figure 13), up from $3.7 billion in 2008. According to the figures for 2010, Japan was the second-largest direct investor in China, with $4.2 billion, after Singapore. We think the process of restructuring Chinese companies and fostering new industries will present Chinese and Japanese companies with opportunities for cooperation and cross-border M&A in key industries. It will be interesting to see exactly how foreign companies take advantage of the wider range of options for their involvement proposed in the *Several Opinions on Further Improving the Work of Foreign Capital Utilization*.

4 21st Century Media, 20 December 2010.

Figure 14: Geographical breakdown of QFIIs (by domicile)

Country (domicile)	Amount ($100mn)	Share (%)
UK	37.90	19.98%
US	28.60	15.08%
Hong Kong	24.00	12.65%
Japan	20.00	10.54%
Singapore	11.50	6.06%
Korea	10.45	5.51%
Switzerland	10.00	5.27%
Netherlands	8.25	4.35%
Norway	7.00	3.69%
Belgium	6.50	3.43%
Canada	5.00	2.64%
Germany	4.75	2.50%
Australia	4.50	2.37%
France	4.25	2.24%
Luxembourg	3.00	1.58%
UAE	2.00	1.05%
Malaysia	2.00	1.05%
Total	189.70	100.00%

Note: Investment limit as of end-September 2010.
Source: Nomura Institute of Capital Markets Research, based on Shanghai Wind Information Co., Ltd

2) Qualified foreign institutional investors as a source of liquidity

We expect to see China's public markets used as a source of capital for restructuring Chinese companies and fostering new industries. As China's key industries will need discerning investors with ample liquidity, we can see foreign investors that have acquired this know-how overseas playing a more active role in these markets.

Since 2002, China has had a "QFII" (qualified foreign institutional investor) system. Under this system, overseas institutions (such as fund management companies, insurance companies, securities companies, commercial banks, and pension funds) that have been licensed by the CSRC are allowed to invest in Chinese securities (such as listed equities, listed bonds, and shares in mutual funds) up to a limit (amount) set by the State Administration of Foreign Exchange (SAFE). As of 17 November 2010, 103 foreign institutions had been licensed by the CSRC, and the limit set by SAFE, as of end-September 2010, was $18.97 billion.

Qualified foreign institutional investors can be expected to have the expertise and the long time horizon needed to provide the liquidity needed by China's key industries. With personal financial assets totaling some ¥1,400 trillion, Japan also has the necessary liquidity. A geographical breakdown of qualified foreign institutional investors (by domicile) reveals that Japan occupies fourth position in terms of investment ($2.0 billion or 10.54% of the overall limit) after the UK, the US, and Hong Kong (Figure 14). In view of the extent of foreign (including Japanese) interest in the QFII system, expectations are high that the number of licenses and the investment limit will be increased.

Foreign investors also have an important role to play on overseas public markets in supplying the liquidity needed to restructure Chinese companies and foster new industries. Investment banks also have an important role to play (in linking issuers and foreign investors), and foreign (including Japanese) investment banks can be expected to play a major role in fostering key industries in China.

It will be interesting to see how China continues to seek to make its industries more competitive.