The Dragon Code

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Shandong SOE reform: A step closer

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Introduction

State-owned enterprise (SOE) reform continues to play a key role in China's restructuring efforts. In particular, Shandong[1] province has started a rather unique reform program, where SOEs in its province are expected to transfer 30% of their capital[2] to the local social security fund. The benefits from this capital transfer are expected to be threefold: a more-diversified ownership structure, better corporate governance and a means to address the potential fund imbalance in China's local social security system. In our view, Shandong's program shows China moving one step closer on its long journey towards SOE reform.

SOE reform and social security funding model

Shandong is the first province to have its local social security fund become shareholders in its SOEs (see "Background of NSSF and other developments"). This initiative is led by Guo Shuqing, Governor of Shandong Province[3] and the former chairman of the China Securities Regulatory Commission (CSRC). As the third-largest province in China, in terms of the number of SOEs, Shandong has 471 SOEs in industries such as coal, steel, autos, engineering, gold mining and agriculture. All of these SOEs are required to transfer a portion of their registered capital (ownership) to Shandong's social security fund. By the end of 2016, the plan is to have all SOEs transfer around 26 billion yuan ($4 billion) in capital[4] to the fund.

A more-diversified ownership structure

While the degree of competitiveness within SOEs can vary, generally speaking, SOEs' profitability and return on assets are trailing behind those of private companies. This can be attributed to the legacy issue of operational inefficiency. One solution to boost efficiency is to introduce diversified ownership.

In the past, unlisted SOEs were 100% owned by the State Owned Assets Supervision and Administration Commission (SASAC).[5] For listed SOEs, the SASAC would own a substantial percentage of their registered capital even though they were publicly listed. SASAC is known for its role in representing the government and advancing policy goals and "social responsibilities." With the launch of this SOE program, transferring a portion of the SOEs' capital to the social security fund would result in a more-diversified ownership structure. Social security funds, which seek to maximize financial returns, are more likely to favor corporate efficiency over policy goals. As such, introducing the social security fund as a shareholder could help invigorate SOEs by having senior management/boards place greater focus on resource allocation and profitability.

[1] Shandong Province is China's second-largest by population as of 2014.
[2] The transfer will be in registered capital (authorized capital), which is the maximum amount of share capital that a company is authorized to issue to shareholders.
[3] Guo Shuqing is an influential authority in China that is known to be a strong advocate of shifting SOE ownership away from the SASAC.
[4] Source: China International Capital Corp. (CICC); Based on the ratio of registered capital to assets for 11 provincial SOE that disclose registered capital, it is estimated that there is 86 billion yuan in registered capital. Thirty percent of this capital equals 26 billion yuan in capital.
[5] The SASAC is a special commission in China, directly under the State Council, responsible for managing the SOEs by appointing top executives, approving merger and acquisition (M&A) activity and drafting laws related to SOEs. As of Dec. 29, 2015, if the subsidiaries in regions, provinces and municipalities are included, the total number of companies SASAC covers is estimated to be well over 100,000 companies.

Better corporate governance

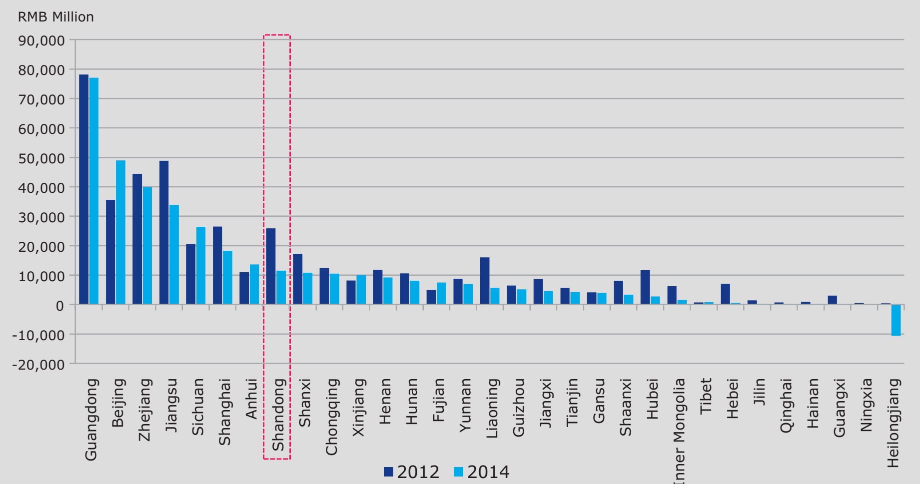
The Shandong reform program could also lead to better corporate governance standards among SOEs. In particular, the change in shareholder structure will likely incentivize SOEs to implement policies that promote better accountability, fairness and transparency. We anticipate positive developments in corporate governance, such as the setting up of a board of directors, establishing an audit system to ensure all provincial-level SOEs meet financial management standards, improving the capital supervision and administration of SOEs and enhancing the decision-making process. With a greater focus on corporate governance and more-defined corporate standards, both SOE companies and their shareowners stand to benefit.

Addressing a potential funding gap

Recently, overall local pension funds in China, accounting for the 31 provinces/regions, were still running a surplus of 400 billion yuan ($62 billion).[6] However, concerns over a future funding shortage are growing, with 10 of the 31 local pension funds seeing their fund balances reduced by 60% to 100% over the past two years.[7] The shrinking balances can be attributed to low investment returns, demographic shifts and/or slower regional growth.

The transfer of registered capital from SASAC to a social security fund could help address potential funding gaps going forward. The reason is in addition to the interest income earned from bond and deposit assets, the fund will also receive equity dividend payments or a portion of the SOE's annual earnings following the transfer.

Annual pension balance across 31 provinces/regions



Source: CEIC, Annual social security revenue less expenditure for each region

6 Ministry of Human Resources and Social Security (MOHRSS), for the year 2015
7 The 10 provinces/regions witnessing a 60-100% or greater decline in the pension fund balance are Heilongjiang, Ningxia, Guangxi, Hainan, Qinghai, Jilin, Hebei, Inner Mongolia, Hubei and Liaoning.

Background of NSSF and other developments

- In China, there are pension funds at both the national and local government levels. The National Social Security Fund (NSSF), the sole national level fund, is the only government pension fund in China able to invest in securities outside of bonds and deposits. In 2000, the central government established the NSSF, managed by the National Council for Social Security Fund (NCSSF), as a strategic reserve for future social security payments, independent from local government pension funds. At present, the NCSSF is responsible for managing 1) the NSSF funds, 2) the government subsidies to the social security accounts for nine provinces[8] and 3) the surplus funds of Guangdong and Shandong provinces' social security funds.[9,10]
- As for local government pension funds, there are 31 provincial/regional/municipal pension funds that have only been invested in bonds and deposits up to now, except for 2) and 3) above, as these funds have not been allowed to invest directly in equities.
- In parallel with Shandong's reform model, in May 2016, the government passed a rule that would permit local pension funds to invest in stocks[11] and private equity funds after detailed fund policies and investment contracts have been officially approved. This rule change is very important as local government pension funds, such as Shandong's, will be allowed to also have equities as assets in their local social security funds, in addition to bonds and deposits.

Conclusion

In our view, the transfer of SOE-registered capital to local government social security funds, as we are seeing in Shandong, is a step closer on China's long march towards SOE reform. We consider it to be a positive development as it is expected to lead to a more-diversified ownership structure, better corporate governance, as well as the replenishment of the potential funding gap for some local pension funds. As active, bottom-up investors in the Chinese equity markets, we have a preference for private enterprises due to their greater tendency to be more aligned with shareholders' interest, but we continue to monitor closely the developments on SOE reform. We use a selective approach with a solid understanding of corporate business models and management quality, to assess the opportunities in the Chinese equity markets.

8 The nine provinces are Jilin, Heilongjiang, Tianjin, Shanxi, Henan, Xinjiang, Shandong, Hunan and Hubei.
9 The total assets under management managed by the NSSF as of Dec. 31, 2014, was 1.536 trillion yuan ($247.36 billion).
10 The NSSF manages part of the overall balance surplus of the enterprise employees' basic pension insurance programs for Guangdong Province since 2012 and Shandong Province since 2015.
11 The amount that can be invested in equities is capped at 30%.

Important information

You should note that this information: