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China's privatization reform-

What happens to share value when Chinese companies participate in the privatization reform of selling state-owned shares?

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Abstract

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This thesis evaluates twelve Chinese companies participating in a privatization reform initiated by the government. The companies were chosen for the reform during spring/summer of 2005, and the participation in the reform means that the companies will sell off state-owned shares and transform them into publicly traded A-shares. In China, A-shares are shares held by domestic investors and denominated in Chinese currency, RMB. This case study shows how share value changes for the twelve companies when they sell off their previously non tradable, state-owned shares. The reform of 2005 was divided into two parts, firstly there were four companies and out of these two were picked. Secondly, there were 42 companies and out of these ten were picked. The results show that share value does change when the company decides to participate in the reform, and ten out of twelve companies show decreasing share value after participating in the reform. However, share value is expected to drop since the market suddenly contains more shares, and because of this there are compensation plans involved. Holders of non tradable share are to compensate holders of tradable shares in different ways, most commonly by giving them between one and four shares for every ten shares they own. Even so, there is a drop in share value and this probably has to do with the market not really believing in privatization just yet and the fact that there are issues and problems to work out regarding the transformation of ownership; for example the transfer of property rights to the new shareholders, and the transformation from a soft to a hard budget constraint.

Key words: China, state-owned enterprises, privatization, shareholders, property rights.

1. Introduction

After about 25 years of growth, investment opportunities in China are some of the greatest of our times. With 1.3 billion people living in China, and a GDP growth twice that of the USA[1] at around nine percent, China provides an interesting investment scene and the transition to a privatized market economy help propel investment interest. If China can make this transition smooth has yet to be seen, but if the country succeeds it will have managed a task that some of Asia's earlier rising powers have not. A part of privatization is the shift from state-owned enterprises to private owning. In China, companies are selling state-owned stock for private investors to buy, and this thesis will address this issue and look at how the stock market reacts to this, in other words how the stock value changes, and how it affects the company being privatized.

1. 1 Question

- **How do selling state-owned shares in Chinese companies affect share value for companies participating in the latest reform of 2005?**

Privatization to the market usually equals a greater performance of the company. In the market oriented economy, the less involvement of the state the better. Since China is evolving towards a market oriented economy, a logical conclusion would be to expect this to be the case in China also. What actually happens when a company goes private in China, does it perform better or worse than before, and why the latter or he former? Who can buy the newly issued shares and what kind of shares are they? What does the transformation imply for the shareholders in terms of property rights? Does private owning mean better and stronger corporate governance?

The latest reform initiated by the government was picked for this reform, in part since there are lots of studies already on the earlier reforms, and also since earlier reforms failed and had to be called back and abandoned. Share value plunged downward, leading the government to start looking for errors and evolve the regulations around the reform. What is happening today, years after the first reform took place? Has the market accepted the privatization reform, reflected by share value not dropping significantly when the company decides to participate, or are they still reluctant? What has happened since the government first introduced the reform of privatization; has the regulations around the reform changed, and what does this imply for the companies participating in the reform today?

[1] Data from www.geoinvestor.com/countries/china/main.html (2005-11-01). Growth rate measured 2004.

1.2 Method

This thesis will show how share value in companies change by participating in the privatization reform. In China privatization might not yet equal higher market value since the involvement of the state might represent that the company is a safe investment. This issue will be evaluated and an explanation as to why share value changes the way it does will be sought. In order to answer the question, a case study of twelve companies will be performed and share value changes in general after companies have sold state-owned stock will be studied. As mentioned earlier, the latest reform announced by the Chinese government was chosen for this study, starting with four companies being chosen for the reform in May 2005 and being followed by 42 companies in June. Out of these two companies were picked from the first part of the reform and ten companies from the second part. This reform will be compared to earlier reforms initiated by the government, and differences in rules and regulations will be pointed out, as well as differences in how the market reacted.

Share value for the period was only available in diagram form meaning the diagrams had to be analyzed, which is not as accurate as analyzing data in table form, but significant points in the diagrams were sought and compared to dates when important decisions were taken. For the A-share indices, data in table form was found from the Shanghai stock exchange and the Shenzhen stock exchange, and changes in the Shanghai A-share index were compared to important events, particularly events such as shareholder meetings in large companies included in the study.

1.3 Disposition

The second chapter will provide some background information on the Chinese stock market; when it was founded, different types of shares and their names, how the stock market was deregulated and the role of the state in state-owned enterprises. The third chapter provides some history of the split share structure reform, and describes the chosen reform; the reform of 2005. In chapter four the companies are presented and results of what happens to share value are shown. Diagrams are provided as well as additional comments when exact data on important days was found, such as what happened to share value on the day when a shareholder meeting took place. In the end of chapter four, movements in the Shanghai A share index during the period June 15 to August 31 are studied, and connected to important days for companies in the study. In chapter five the data is analyzed, divided into discussions around why share price decline, comparing this reform to earlier, problems regarding property rights and budget constraints, and if the Chinese economy is ready for privatization. In the end two appendices are attached, the first one showing data for the A share indices June 15 to August 31, and the second showing some Chinese companies listed on the Hong Kong stock exchange that have managed to show increasing share value despite Chinas bearish stock market.

2. The stock market in China

In China, stock and share trading begun in the nineteenth century and maybe even earlier. The first stock market was set up in 1891 in Shanghai, but was shut down by the Japanese in 1941. Today, the stock market is made up of three stock exchanges; the relatively new Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), and the older Hong Kong Stock Exchange (SEHK).The SSE and SZSE were established around the same time, 1990 and 1991 respectively, and are both located in the mainland. They have more than 500 listed companies each. SEHK was founded in 1947. In 1986, a trading counter was established by the Industrial and Commercial bank of China and four stock exchanges merged and formed the Hong Kong Stock Exchange[2].

A vast majority of the exchange quotations today are state-controlled enterprises. The stock market in China has traditionally been known for withholding information about its companies, but that has come to an end since the introduction of "Securities Law of the People's Republic of China" in 1999, which forces exchange noted companies to provide annually, quarterly and interim rapports and also to inform the market if anything unexpected happens[3].

As we can tell, the Chinese stock market has a relatively short history. Changes in outstanding shares are complicated. China is undergoing a transition to from a planned economy to a socialist-market economy and this naturally reflects on the stock market. The rapid growth in the Chinese economy, the open door policy and the reform measure have remarkably improved China's conditions for market access and enlarged the degree of openness of its markets[4].

There are different types of shares in the Chinese stock market, and the following page will name and explain them[5]. The companies included in this study have only issued A-shares, and the previously non tradable C-shares held by the state are being transformed into A-shares and released to the public. In other words, only A-shares and C-shares are relevant for this thesis,

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[2] Facts from this paragraph obtained from *En introduction till Kinas aktiemarknad*, Grip, 2002, p 18-21
[3] Facts from this paragraph obtained from *En introduction till Kinas aktiemarknad*, Grip, 2002, p 28
[4] Facts from this paragraph obtained from "China in the world trading system", Abbot, 1998
[5] Different share types obtained from http://www.sinomania.com/CHINASTOCKS(2005-11-03), http://www.stockmarket.cn/exchange.htm(2005-11-03) and *En introduktion till Kinas aktiemarknad*, Grip, 2002,p.30-32.

but in order to provide a full picture of the Chinese stock market, the other share types are presented as well.

A-shares	A-shares are issued by Chinese companies and listed on the SSE or the SZSE. They are held by the Chinese public, denominated and payable in Chinese currency. As of June 2003, China approved foreign institutional investors to invest in A-shares, provided they fulfil the criterions.
B-shares	B-shares are denominated in Chinese currency and payable in foreign currency; they are designed for foreign investors, but as of February 2001 Chinese citizens with access to foreign currency may also buy B-shares. B-shares traded on the SSE are denominated in US dollars, while B-shares traded on the SZSE are denominated in Hong Kong dollars.
C-shares	C-shares are denominated and payable in Chinese currency and held by state-owned enterprises such as state-owned companies and banks. They are not publicly traded.
H-shares	H-shares are floated and listed on the Hong Kong Stock Exchange. The best rated H-shares are rated “red chips”. There are two definitions of “red chips”; the most common is that the company has to be registered in The People’s Republic of China with a percentage ownership of 35%. The second is that the company is registered in Hong Kong, but has most of its company activity in the People’s Republic of China.
N-shares	N-shares are floated and listed on the New York Stock Exchange
L-Shares	L-shares are from Chinese companies listed on the London Stock Exchange
S-shares	S-shares are China related shares quoted on the stock exchange in Singapore. A lot of Chinese companies rely on the Singaporean stock exchange for finance.

Around two third of the shares in the Chinese stock market are non tradable, and there are three different types of non tradable stock in a Chinese company[6];

- state owned stock,
- stock held by juridical persons
- stock held by the company’s employees.

[6] www.oemagazine.com/fromTheMagazine/sepol/busspot.html (2005-11-03)

Normally, it will be evident from the company's financial reports which kind of stock that the company has, and how much of it.

2.1 The deregulation of the Chinese stock market

Since the beginning of the 1990s, China has been deregulating businesses from being state-owned to becoming privately-owned in order to prepare Chinese companies for international competition and develop towards a market oriented economy[7]. This process of privatization frees businesses from being government-owned, and opens up the market for private investors and public trading. This is good news for the market forces, but privatization might also have a negative impact on workers. Being hired to work in a SOE (state-owned enterprise) is different from working in a privately-owned enterprise, for a start the privately owned enterprise cannot afford excess workers. The company will have to cut costs and might have to lay off workers, and China faces a problem of unemployment. As a result of deregulation, the Chinese government predicts a decrease in the workforce of 20 million workers in the next five years, due to government requirements that all workers need receive a certificate through Ministry of Personnel and Ministry of Labour, in order to be qualified for a specific job in the public sector[8]. These 20 million workers must be allowed to be retrained or move into occupations in the privately owned sector, which can be a painful process.

2.2 The role of the state in state-run enterprises

A state-run enterprise's fundamental tasks is to "provide society with material products and labour services, which will provide tax for the government and enterprises with profit in order to reinvest and further develop the business and improve the conditions for the workers[9]". Since the company is state-owned, in other words owned by the people, the company is supposed to be run according to national interest. A privately-owned enterprise, however, usually has slightly different priorities, and profit-maximization is normally the most important goal.

[7] www.oemagazine.com/fromTheMagazine/sepol/busspot.html (2005-11-03)
[8] www.technologysource.org/article/globalizing _the_knowledge_economy/ (2005-11-04)
[9] Citation obtained from *Chinas Economic reform*, Totten and Zhou, 1992, p 53

2.2.1 Property rights

Since the ownership of Chinese companies is shifting from state-owned towards more privately owned in the transfer of state-owned shares to A-shares, China's authorities have focused attention on defining clearer property rights within organizations and corporate governance. Property rights can be defined into two important parts; **income rights** and **control rights**, where income rights mean having the right to use goods or services to obtain income as money or goods and services, and control rights represent the right to use goods or services in production and exchanges[10]. In SOEs, property rights are exercised by the state council. Transforming a SOE into a privately or partly privately owned company is a slow process, in part since defining property rights can be very tricky. In SOEs, property rights are well protected and these enterprises enjoy favourable treatment from the government when it comes to access to capital, raw materials etc[11]. Privately owned companies suffer from unclearly defined property rights, which make the transition even harder. Because of the share transfer reform, the government has put focus on issuing regulations regarding property rights in order for the transformation of ownership to go smoother. As for corporate governance, a major focus area has been to allow passive minority state ownership in state owned enterprises, and diversify ownership in companies in general[12].

2.2.2 The state as a block holder

As mentioned earlier, there are different types of ownership in a Chinese company. Shares can either be state-owned, legally-owned, employee-owned or privately owned, and depending on which type of ownership is dominant, different situations arise.

The companies participating in the case study of this thesis all have in common that the state is the major shareholder, owning between 60 and 85 percent of the shares. The state is therefore the block holder[13] of shares in all of the companies, enjoying most of the property rights in the company. The implications of block holders in companies can be positive or negative. The state as a block holder can eliminate the free riding problem[14] in companies;

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[10] S*hareholders and the atom of property,* Business and society, 2000, vol 39:1, p 49-75

[11] *Shareholding structure, depoliticization and firm performance- lessons from China's listed firms,* Wong, Opper and Hu, Economics of transition, 2004, vol 12:1, p 29-66

[12] *The state as a shareholder*, A World Bank Country Study, 1997.

[13] Block holder: a shareholder that owns more than ten percent of a company's shares (Huang and Xu, 2005). According to La Porta *et al*, 1999, only 24 percent of listed companies worldwide have a dispersed ownership structure, the rest have at least one block holder.

[14] Free riding problem: small shareholders benefiting from large shareholders putting in work and effort to make the company profitable, and therefore raise the value of the shares (Ayres and Cramton, 1994)

since their shares are non tradable, other shareholders cannot come together and buy the majority of the shares for the purpose of gaining influence over the company, raising firm value with their new strategies and allowing minority shareholders free ride. The state is constantly monitoring the company and since their shares are non tradable, they have no real interest in raising share value, and therefore minority shareholders cannot free ride. On the other hand, block holders that large normally control the companies, and have the advantage of being able to push through with decisions favouring themselves and making minority shareholders stand back. The existence of block shareholders may also reduce market liquidity, since fewer shares are held by market participants[15].

2.2.3 Minority shareholders and investor protection

Around two-thirds of the total shares of listed Chinese companies are non tradable, and often in government hands[16]. This means that the majority of all shareholders usually hold non tradable shares, receiving no part of the company's revenues but being the winners when stock prices increase since they hold the major part of the shares. The minority of the shareholders hold tradable A-shares, receiving dividends from the company's revenues, and also benefiting when stock prices increase, but having the disadvantage of not having an important voice when it comes to matters of the company, which in turn means they might have to see their interests forsaken. Minority shareholders can be expropriated in numerous ways; block holders might overpay executives, sell shares in the company at below market prices to another company they own or sell assets and output at below market prices if it benefits them[17]. Investor protection turns out to be crucial[18] because controlling shareholders may very well expropriate minority shareholders, and minority shareholders face a risk that their return on investment will never materialize. In China, the CSRC[19] was developed partly for investor protection purpose. Examples of investor protection the CSRC has accomplished are raising funds to compensate investors that have been subjected to collapse of brokerages and financial institutions, and needing the majority of the holders of tradable shares to vote in favour of the privatization reform for the company to participate[20]. Investment protection is important also from a financial point of view, according to La Porta *et al* (2002)[21], who not surprisingly found that investors are willing to pay higher prices for shares when their

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[15] *Large shareholders as monitors,* Maug, Journal of Finance Vol 53:1, p 65-98, 1998
[16] *En introduktion till Kinas aktiemarknad,* Grip, 2002
[17] *Investor protection and corporate governance*, La Porta et al, Journal of Finance 2000,vol 58, p3-27
[18] *Expropriation, regulation and firm value,* Berkman, Cole and Fu, University of Auckland, 2003
[19] China Securities Regulatory Commission
[20] http://english.people.com.cn/200411/08/eng20041108_163127.html (2005-01-20)
[21] *Investor protection and corporate valuation*, La Porta et al, Journal of Finance 2002, vol 57:3, p 1147-1170

interests are protected. Better investor protection is rewarded with higher firm valuations, and when regulations are drawn up on government level to protect minority shareholders, a company with weak corporate governance benefits by rising share value[22].

2.2.4 Issues regarding the state as a shareholder

In China, the involvement of the state has been considered a security since investors don't have to worry about the company going bankrupt all of a sudden. Up until now, state-owned companies in China have had leading roles in economic stabilization and development, and have occupied a large proportion of the GDP, investment projects, foreign cooperation etc. State-owned companies also presented important policies to ensure the supply of utility products and services for social needs[23]. At the same time, state-owned enterprises have brought a lot of problems. Their heritage from a planned economy has resulted in problems such as excess employment, low productivity, high social costs and wasting of resources. It is hard to tell just how high these losses have been for these companies, due to lack of financial reports from this era, but it can be assumed that over 50% of these companies have made losses during the 1990s[24]. Despite of this, the Chinese government has not let many of these state owned companies go bankrupt, since there are high social costs associated with closing down factories, such as unemployment. In many areas there have been social disturbances due to closing down factories.

2.3 Reforms regarding state owned enterprises

During the market introduction of the 1990s, the Chinese government gave priorities to SOEs, and most of the quoted companies in the SSE and SZSE today are state-owned enterprises[25]. The state now wants to keep industries in large basic industries such as the weapon industry, and share the ownership in others. The SOEs have been heavily protected before and investors have followed political decisions rather than company value, since this has been more accurate. In the near future, if the market force is allowed to fully take over, supply will now be determined by demand of the market.

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[22] *Expropriation, regulation and firm value: evidence from events in china,* Berkman, Cole and Fu, University of Auckland, Dec 2003
[23] http://www.nscerd.org.vn/english/DMDN/tqcs.asp (2005-11-21)
[24] *En introduktion till Kinas aktiemarknad,* Grip, 2002, p 13-15
[25] Facts from this paragraph obtained from *En introduction till Kinas aktiemarknad,* Grip, 2002, p 14

3. The split share structure reform

Around 450 billion of stock market capitalization in China is locked up in state-owned shares, leaving only 150 billion to be publicly traded, although a lot of the capital that is supposed to be freely traded is looked up in institutional portfolios and do not change hands[26]. The introduction of the stock market in China represented an important step towards a market oriented economy. Privatization of companies is a gradual process, and the listing of companies on the stock exchange is a promising start. The process of privatization usually begins by listing companies on the stock market, in which the state keeps a large fraction of the shares and therefore remains the biggest influence in the company[27]. Since the state-owned stock are non tradable, the state can therefore rest assure their ownership in the company remains unchanged. As the economy moves towards being more and more market oriented, the state sells off these shares and decreases it's ownership in the company. The shares that were previously non tradable become tradable.

The privatization of enterprises in China begun with smaller and medium companies, and has now evolved to including larger companies as well since the latter half of the 1990s. Privatization of small and medium enterprises has been carried out by the conversion of state-owned to employee-owned companies, or the buyout by a small number of parties, such as managers[28]. Since 1997, the government has been working on reforming the social security system in line with selling state owned shares in state owned enterprises. Back then, the government had just changed the retirement system from pay as you go to official funding, and needed cash to fill up the gap representing workers that had not participated in the pay as you go system. This gap increased rapidly from year to year. At the same time, privatization of enterprises was about to take off and in November 1999 the government handpicked ten stable, high profit-companies, to start selling off their state owned shares. The selling of shares started for the immediate purpose of covering the gap in the social security system. Two companies started selling state-owned shares, but their shares were priced close to market value despite their excellent performance, which led to only 80 percent of the shares being sold. The reform had to be stopped before the other eight companies had started selling, and was put on hold. Since mid 1999, Chinese share prices rose, almost doubling in two years. Then they turned downwards, and have continued to drop ever since.

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[26] http://www.bjreview.com.cn/En-2005/05-27-e/people-27.htm (2005-11-15)
[27] http://www.rieti.go.jp/en/china/05120701.html (2006-01-21)
[28] http://www.rieti.go.jp/en/china/05120701.html (2006-01-21)

A year and a half after the disappointing results of the first reform were given, rules regulating selling state-owned stock were drawn up regarding market prices of state owned shares and compensation from the owners of non tradable shares to owners of tradable shares. When the state shares become tradable, holders of the former non tradable shares gain money by selling them, while holders of tradable shares often have to see the value of their shares decrease, because now there is a larger supply of shares on the market and this decreases share value. When a company goes public in China, only the newly issued stock are allowed to be traded on he stock exchange[29]. There have been ways for shareholders to go around this and still realize the value of their shares, and this has given rise to various types of abuses. Holders of tradable shares should therefore be compensated this time, the government stated and hoped that this would change the outcome of the reform to the better. This compensation could be done in different ways, for example via options, partial stock splits and warrants[30].

A new reform took off in 2001. The income from selling state owned shares was this time as well supposed to cover social security funding, but the market plunged 30 percent and the reform was abandoned like the reform of 1999. Even though holders of tradable shares were compensated, share prices still dropped rapidly due to concern about a possible worsening of supply and demand on the stock market[31].

3.1 The split share structure reform of 2005

We know now that the state had tried twice before the reform of 2005 to upload state shares, and that each time was a failure and had to be abandoned. The stock market in China has for the past four years been bearish, and the split share structure has been to blame for the country's sluggish stock market[32]. Since 2003, China's economy has grown at an accelerating rate, but this has not had a positive impact on share prices. Though some Chinese companies listed on the Hong Kong stock exchange have increased share value[33], most Chinese company share value has decreased.

[29] Information about the split share structure reform from http://www.nicmr.com/nicmr/english/report/repo/2005/2005aut04.pdf (2005-11-21) and http://www.csrc.com.cn/en/homepage/index_en.jsp (2005-11-20) and www.rieti.go.jp/en/china/05120701.html (2005-11-21)

[30] http://www.nicmr.com/nicmr/english/report/repo/2005/2005aut04.pdf (2005-12-09)

[31] http://www.chamber.org.hk/info/the_bulletin/sept2002/china_economic_update.asp (2005-11-22)

[32] http://www.bjreview.com.cn/En-2005/05-27-e/people-27.htm (2005-11-21)

[33] See appendix 2 for illustration of Chinese companies listed in Hong Kong who have managed to increase share value despite a bearish Chinese stock market

In February 2004, the State Council issued guidelines to facilitate the reform of selling state owned shares. China Securities Regulatory Commission (CSRC), the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), and the Ministry of Finance (MOF) were founded to supervise the reform and be of guidance to companies selling state-owned shares[34].

To protect minority investors, the CSRC announced a reform in April 2005 that stated two thirds of the owners of tradable shares must vote in favour of a decision for it to be accepted. Four companies were picked for a new privatization reform after this announcement, on May 9, 2005, and from this date until June 17 the share holders voted about whether they should participate in the reform or not. In between May 9 and June 17, the companies' shares were suspended from trading during which time only one of the companies said no to participate in the reform. The main issue of the program is not that all shares should be allowed to float, but to equalize trading right differences between the different share holders, so that holders of non tradable shares should not be able to force the company into an unfavourable cause of action in the future[35].

In early June, due to his reform, share prices fell to the lowest level in eight years. In response, CSRC issued a new regulation on June 16 to urge companies to buy back their own shares. On June 17 they introduced a lower limit on ratio of shares to stop the share price from falling even lower. 42 companies were chosen for the second part of the reform on June 20, and this time the lesson was learned from the first part of the reform.

Holders of non tradable shares were to compensate holders of tradable shares in different ways[36]. In between June 20 and August 19 all companies shareholders voted in favour of the reform. The companies' shares were not suspended from trading during the whole period June 20 to August 19, but they were suspended around the time that the shareholders voted in the matter, which varied from company to company. The reason for suspending the shares is to minimize the risk of inside trading, so that insiders with access to full information about a shareholders decision cannot take advantage of the situation and make money out of it. The 42 companies have a combined market value of RMB 302.1 billion, which is fifteen times that of the first four and represents ten percent of total market value. In this group there are companies such as Baosteel, China Yangtze Power and Shenergy with blue chip rated shares. **Blue chip rating** describes powerful large companies, and people trust these stocks and the

[34] http://www.csrs.com.cn/english/homepage (2006-01-21)
[35] http://www.nicmr.com/nicmr/english/report/repo/2005/2005aut04.pdf (2005-12-09)
[36] http://www.cityweekend.com.cn/en/beijing/cib/2005_08/story.2005-07-29.0654759712 (2005-11-24)

companies for their stability and profitability. The blue chips are the leaders of the security exchange and usually have a higher price[37].

CSRC announced August 26 a draft of rules that would include all companies listed on the exchange to be privatized. September 4, the draft was finished and 40 companies announced they would participate in the reform and begin reform efforts, encouraged by the authorities' statement they would receive preferential treatment.

The stock exchanges will act as regulators to coordinate and direct the split share structure reform of listed companies and handle the procedures that come with the listing of non-tradable shares. Shareholders owning more than five percent of former non-tradable stock may sell their shares after a twelve month lock up period. From the date that the implementation plan is accepted, the shareholders that are entitled to sell have to wait twelve months, and after that period is over they may sell a maximum of five percent of the total shares in the listed company during the first twelve months. During the first twenty four months they may sell a maximum of ten percent of the total share value in the listed company[38]. These are minimum regulations, and the companies may very well decide to prolong the suggested period before the state is allowed to sell their shares.

[37] http://www.nicmr.com/nicmr/english/report/repo/2005/2005aut04.pdf (2005-12-09)
[38] Rules and regulations around the split share structure obtained from http://www.csrc.com.cn/en/homepage/index_en.jsp (2005-12-16)

4. Case study and results

This case study starts by presenting some background information and results for two of the four companies that were picked for the first part of the reform in 2005:

- Shanghai ZiJiang Enterprise Group Co. Ltd (Shanghai)
- Sany Heavy Industry Co. Ltd (Shanghai)

Background information and results for the ten out of the 42 companies that were chosen for the second part of the reform 2005 will follow:

- Aelous Tyre (Shanghai)
- Baoshan Iron and Steel (Shanghai)
- China Yangtze Power (Shanghai)
- Citic Securities (Shanghai)
- Handsome Electronics (Shanghai)
- Jiangxi Changli Automobile Spring (Shanghai)
- Shandong Luxi Chemicals (Shenzhen)
- Shenergy (Shanghai)
- Shenzhen Agricultural Products (Shenzhen)
- Sinochem International (Shanghai)

As for the results, focus will be on checking if the share price has fallen in general compared to the A-share index, how share price reacted the day the shareholders approved the reform plan (if data on share value is available on that day), and in what direction the current share price seem to be going. For those companies where compensation plans were found, these were included in the study. Since there are rules stating the state may not start selling their shares for at least a year, the companies included in the study have not yet started selling their shares. Voting yes to participating in the reform, and going public with a compensation plan for holders of tradable shares, are however big decisions that will affect share value and will be seen in the results[39].

[39] Diagrams from the Hong Kong stock exchange http://www.hkex.com.hk/csm/priceMove.asp?LangCode=en&StockCode=**6000469**&mkt=sh (stock code changes depending on which company is studied)

4.1 Companies from the first part of the reform

4.1.1 Sany Heavy Industry[40]

Total assets	43 200 million RMB
Market value	40 700 million RMB
P/E	12.5
Nontradable shares	75 percent
Stock code	Shanghai 600469

Compensation plan: The holders of non-tradable shares will compensate holders of tradable shares by giving them 3.5 shares for every ten shares held, plus a bonus of RMB 8 for every ten shares held. The bonus shares will start trading on June 17, and the holders of non-tradable shares will in total give the holders of tradable shares about 21 million shares in compensation.

Company information: Sany Heavy Industry group was set up on November 22, 1994. The company was listed on the Shanghai Stock Exchange January 3, 2000. Sany Heavy Industry is a transportation equipment maker, mostly involved in manufacturing engineering machinery, machinery of building, road buildings and hoist machinery. It is a large enterprise with around 5000 employees, based in the southern Hunan province. The shareholder meeting where the reform was approved by 93.44 percent of the holders of tradable shares was held on June 10, 2005.

Comments: Share value has since 2003 been higher that the Shanghai A share index. The share was suspended on May 9 and resumed trading on May 11, when it reached its ten percent increase limit. In early June 2005, and around June 10 when shareholders approved the reform, share value was still rising. Around this time the share was suspended (it was suspended on June 2), and when it resumed trading on June 15 share value rose by RMB 1.97

[40] Company information on Sany obtained from http://www.sany.com.cn/english/kj/kj_bsh.htm (2005-12-01) and http://www.chinastock.com.cn/english/ChinaWatch1.jsp?catname=IssuingListing (2005-12-01)

to 21.65[41]. On the day the bonus shares were listed, June 17, share price declined by 30 percent, which symbolizes the first part of the big drop in the diagram. After June 17, share value dropped substantially to A-share index level, and it hasn't recovered yet. Under pressure from its shareholders, Sany improved its compensation plan on June 25 to the one stated above. Since July, share value has been low, surging sharply on July 27 and hitting the ten percent daily limit.

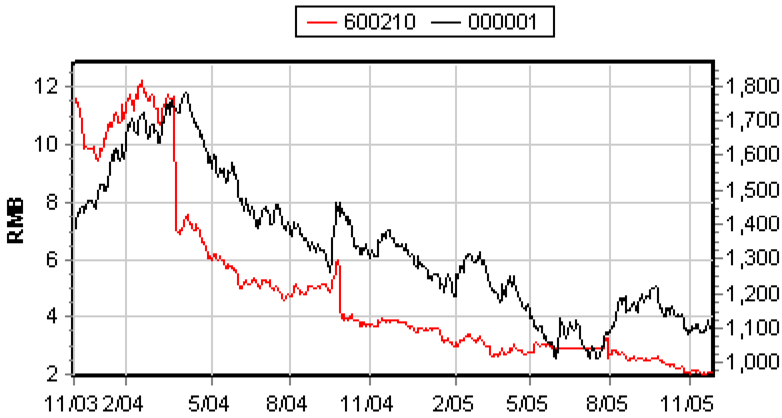
4.1.2 Shanghai Zijiang Enterprise Group Ltd[42]

Total assets	67 300 million RMB
Market value	39 900 million RMB
P/E	18.5
Nontradable shares	58.5 percent
Stock code	Shanghai 600210

Compensation plan: The owners of non tradable shares will give the owners of tradable shares three shares for every ten shares held.

Company information: Shanghai Zijiang Enterprise Group is in the printing and plastic products industry, with a main focus area on producing PET-bottles, bottle caps, labels, cardboard, packaging film etc. It has a close cooperation with beverage giants such as Pepsi and Coca Cola, and is one of the two largest producers in this market. The rapid growth in the Chinese market has increased the demand for plastic packaged bottles.
The company went public on the Shanghai Stock Exchange in August 1999, listing 85 million A-shares and raising 650 million RMB. It is the largest private conglomerate in Shanghai, effectively controlled by its founder who owns 34 percent in Zijiang Enterprise Group.
Shanghai Zijiang Enterprise Group has experienced some funding pressure and execution risks, while trying to grasp opportunities in the PET-bottle market and be a first-mover. This funding gap has had to be financed by debt, resulting in high leverage and putting constraints on the company's credit rating which is BB+.
The shareholders approved the reform on June 13, 2005, when 77 percent of the shareholders voted in favour of the reform.

[41] http://www.chinastock.com.cn/english/ChinaWatch1.jsp?catname=IssuingListing (2005-12-03)
[42] Company information on Zijiang Enterprise obtained from http://www.zijiangqy.com/ (2005-12-03)



Comments: Share value was high and above the index until beginning of 2004, but since then share value has fallen below the A-share index and stayed there which may be connected to the fact that the company has had funding problems which would reflect negatively on share value. The share was suspended May 9 and resumed trading May 12, when share value reached its upper increase limit. In between June and August 2005, share price stabilized, though it did not manage to reach up to the index. The last couple of months it has dropped to a really low market value, way below the index.

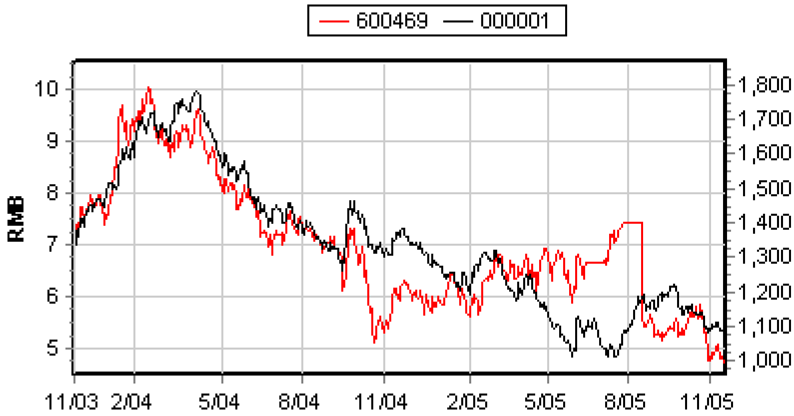
4.2 Companies from the second part of the reform

4.2.1 Aeolus Tyre Co Ltd[43]

Total assets	22 000 million RMB
Market value	16 900 million RMB
P/E	22.1
Nontradable shares	70.6 percent
Stock code	Shanghai 600469

Company information: Concern Aeolus Tyre Co. Ltd was founded in 1965, and went public on the Shanghai exchange in 2003. The company focuses on manufacturing truck tires and giant tires. The latest years it has been showing really high gains from sales. The company ranks 37th in the world tire industry, and the development of new products has contributed a lot to the performance of the company. Since last year a couple of different engineering tires were developed and produced and welcomed by the market. The company has become the biggest engineering tire production base in China.

[43] Company information on Aeolus Tyre obtained from http://www.technoopttorg.com.ua/en/providers.php (2005-12-05) and http://www.echinachem.com/English/Information/ShowInfo.aspx?infoid=8ecf03d6-f1a7-4144-99f0-55b875898ef5 (2005-12-05)



Comments: Aeolus Tyre's share has pretty much followed the index up until October 2004, when it dropped in value and started recovering in November. Share price climbed until it reached the index around March 2005, and outperformed the index for a couple of months thereafter. It dropped in June but it seems the market believed in the privatization and share price has been rising since June during the announcement that Aeolus would participate in the reform. Share price rose until it reached a peak in August and then fell sharply. Since then, share price hasn't recovered but rather surged to an even lower level.

4.2.2 Baoshan Iron & Steel[44]

Total assets	642 600 million RMB
Market value	856 300 million RMB
P/E	6.5
Nontradable shares	77.9 percent
Stock code	Shanghai 600019

Compensation plan: The owners of non tradable shares will give the owners of tradable shares 2.2 shares for every ten shares held and a European call option with a strike price of RMB 4.5 and 378 days to expiry. The parent Baosteel Group will also guarantee a price floor; if the price falls below 4.53 RMB they will buy back the shares outstanding up to a total purchase amount of RMB 2 billion. The plan is for Baosteel Group to hold 67 percent of total outstanding shares in three years.

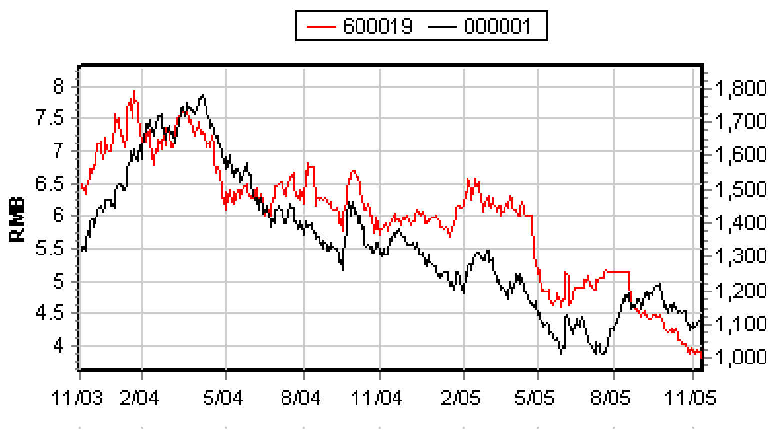
Company information: Shanghai Baosteel Group Corporation (Baosteel) was set up on November 17, 1998, by the parent Baoshan Iron and Steel Company. Baosteel was listed on the Shanghai exchange on December 12, 2000. At the time, this was the largest ever share offer in China's security market. 450 million shares became tradable, representing 22.1 percent of total tradable shares.

[44] Company information on Baosteel obtained from http://www.chinaesteel.com/more/morec.htm (2005-12-01)

Baosteel is the largest and most modernized iron and steel company in China and it has a Standard and Poor rating of BBB+, as of December 6, 2004. Baosteel is also blue chip rated.

Baosteel is the main supplier for industries such as automobile steel, oil and gas exploitation, stainless steel, household electric appliances steel, food and beverage packing steel and metal production steel. Baosteel is an internationally known company, leading them to be the first of its kind in the competitive industry and the manufacturing sector in China to enter the world's top 500 enterprises.

The company was picked for the second part of the reform on June 19th 2005, and on June 20th 2005, all major investors received a fax of Baosteel's intended reforms. On August 12, Baosteel had a meeting for the shareholders to discuss the reform, where 99.957 percent of the holders of tradable shares, and 100 percent of the holders of non tradable shares present at the meeting voted in favor of the plan[45]. After one month's suspension, Baosteel's shares resumed trading again on August 18. Baosteel will have to pay around RMB 4.08 billion in compensation for the state-owned shares.



Comments: As we can see, Baosteel's stock has dropped in value since 2004, but so has the A-share index and Baosteel still managed to stay above the A share index which has to be considered a good performance. The stock closed at RMB 4.89 when it was suspended from trading on June 17 due to pending details around the reform. From July, stock market value increased, indicating the market had a positive outlook of the share reform. Even though the reform was expected by the market, the largeness of the reform was surprising. Baosteel's

[45] Information on when shareholder meeting was held from http://pacificmarkets.blogspot.com/2005/06/china-play-state-owned-shares-disposal.html (2005-12-05)

share rose from beginning of July and kept rising until August, when the shareholders vote in favour of privatization. The shareholders' meeting was held August 12. August 18, when Baosteel's share resumed trading, share price was steady. Since August though, Baosteel's share has slid 6 percent. The parent company Baosteel Group, has tried to avoid further decline of the share by guaranteeing that they will buy the stock if the stock price falls below RMB 4.53 after 14 October 2005 and six months from then, providing a floor for their shareholders.

4.2.3 China Yangtze Power[46]

Total assets	331 300 million RMB
Market value	641 800 million RMB
P/E	20.9
Nontradable shares	70.4 percent
Stock code	Shanghai 600900

Compensation plan: According to the plan, the company is to compensate holders of tradable shares 1.67 shares and RMB 5.88 in cash for every ten shares held. Furthermore, the largest shareholder, China Three Gorges Project Corporation said once the non tradable shares become tradable, they would be held for at least 24 months with its stake in the company being no less than 51% before 2015. The company also said that once the shareholder's meeting approved this plan, as it did August 5, it would offer tradable shareholders with 1.5 shares warrant for every ten shares held.

Company information: China Yangtze Power Co. Ltd, CYPC, was founded in 2002 and listed on the Shanghai Stock Exchange in November 2003, with a total capital share of 7,856 million RMB. 63 percent of the share capital belongs to China Three Gorges Corporation, 7.39 percent belong to five other promoters and 29.61 percent are held by public share holders. In other words, about 70 percent of the share capital is state owned. A chart better illustrates the ratio of ownership in CYPC:

[46] Company information for CYPC obtained from http://www.cypc.com.cn/en/TitleList.jsp?cateid=102685 (2005-12-07)

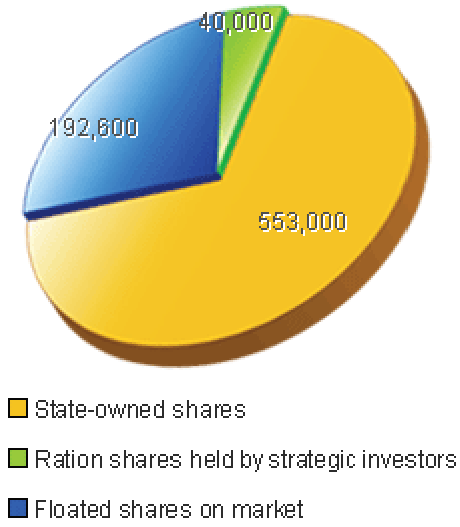
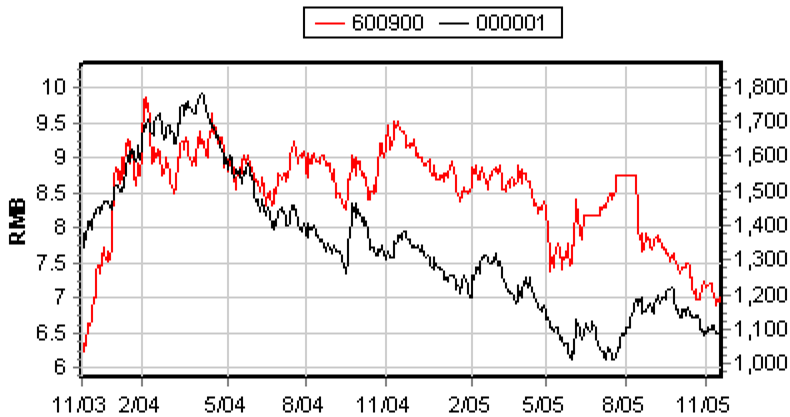


Illustration from http://www.cypc.com.cn/en/TitleList.jsp?cateid=102709 (2005-11-12)

CYPC is the biggest hydropower project listed at the moment. The company was picked for the second part of the reform and a share sale plan was released on August 4, 2005. On August 5, 94.3 percent of the holders of tradable shares voted in favour of the stock disposal plan at the share holders' meeting.



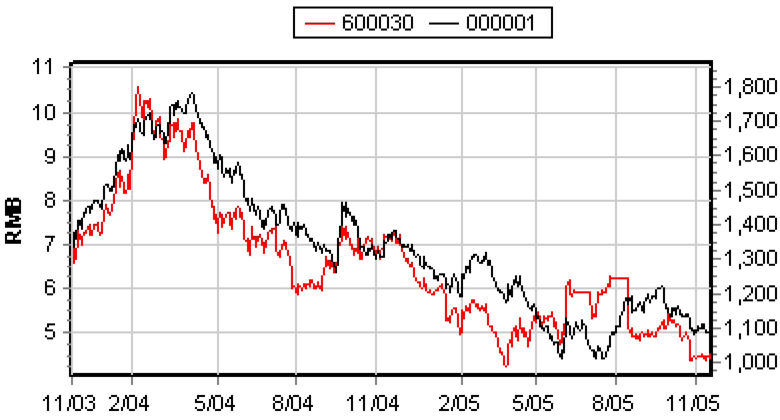
Comments*:* Since the listing in 2003, CYPC share price rose steadily and has stayed above the Shanghai A-share index since July 2004. In May 2005, the share price dropped, but recovered quickly and rose in July 2005 when the share sales plan was revealed, indicating the market had a positive outlook on the share sales plan and on CYPC participating in the reform. Share value stayed steady in July and then continued rising. The compensation plan was released on July 21, and the market reacted positively by a rising share value, making the company more appealing to investors. When CYPC's share resumed trading on August 15, share value rose 14.39 percent[47]. The company said its parent China Three Gorges Corporation will buy back warrants and will lift dividends to sweeten compensation for losses[48]. Share price reached a peak in August, around RMB 8.75 per share, when shareholders voted in favour of the reform. After August, share prices decreased despite the A-share index rising. All in all, the history of share price movement tells us CYPC has a strong share and probably will stay above the index despite the last couple of months of a decreasing share value. CYPC is blue chip rated, which adds to the belief that it may very well survive privatization without dropping too much in value.

4.2.4 Citic Securities[49]

Total assets	132 100 million RMB
Market value	146 900 million RMB
P/E	84.6
Nontradable shares	83.9 percent
Stock code	Shanghai 600030

Compensation plan: The owners of non tradable shares will give the owners of tradable shares 3.5 shares for every ten shares they own.

Company information: Citic Securities is a venture capital company which provides financial services such as direct investment, strategic business alliance and other consulting services. It was founded in 1988, and is today the brokerage arm of Citic Capital. In January 2003, Citic Securities was listed in Shanghai Securities market. The compensation plan was approved August 4.



[47] http://www.chinastock.com.cn/english/ChinaWatch1.jsp?catname=IssuingListing (2005-12-01)
[48] http://www.bloomberg.com/markets/stocks/regional_indices.html (2005-12-07)
[49] Company information for Citic Securities obtained from http://www.citicfuture.com.cn/english/aboutus.htm (2005-12-01)

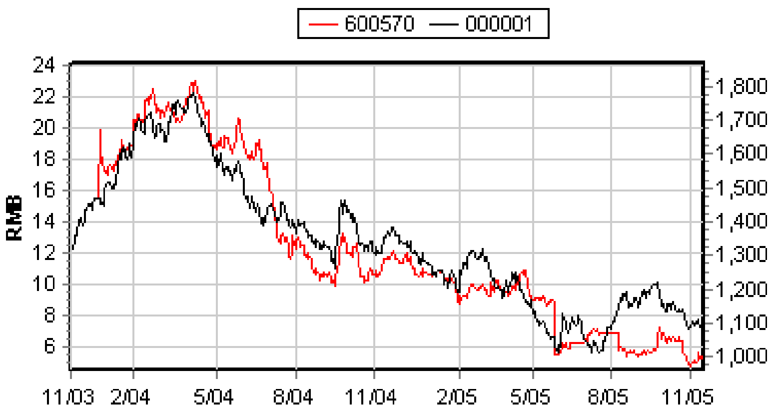
Comments: Most of the time since 2004 share price stayed below the index. In June when Citic Securities was chosen for the reform, share value declined, but then quickly rose again when the shareholders approved the compensation plan implying the market liked the compensation plan. It dropped in July but rose again and peaked in August, indicating that the market believed in Citic Securities participating in the reform. Since August share price has fallen and stayed below the index. In November, share value was low and below the index.

4.2.5 Handsome Electronics Ltd[50]

Total assets	4 500 million RMB
Market value	6 300 million RMB
P/E	18.8
Nontradable shares	75 percent
Stock code	Shanghai 600570

Company information: In December 2003, Handsome Electronics was listed on the Shanghai Stock Exchange Market. 17 000 000 A-shares was listed and started trading, to a value of RMB15.53 per share. The state owns most of the shares in Handsome Electronics and remains very much in control. Handsome Electronics is a software development company, specializing in software systems for the financial service industry, transportations etc. According to a ranking by China's ministry of Information Industry, Handsome Electronics ranked 24th among the top 100 software companies in China.

Handsome Electronics was chosen for the second part of the reform and this announcement was made on July 17. Their stock was suspended from trading on July 17 2005, and resumed trading again August 18.



Comments: Handsome Electronics' share price was doing really well in the beginning of 2004, and stayed above the Shanghai A-share index until July 2004. Since then, the share

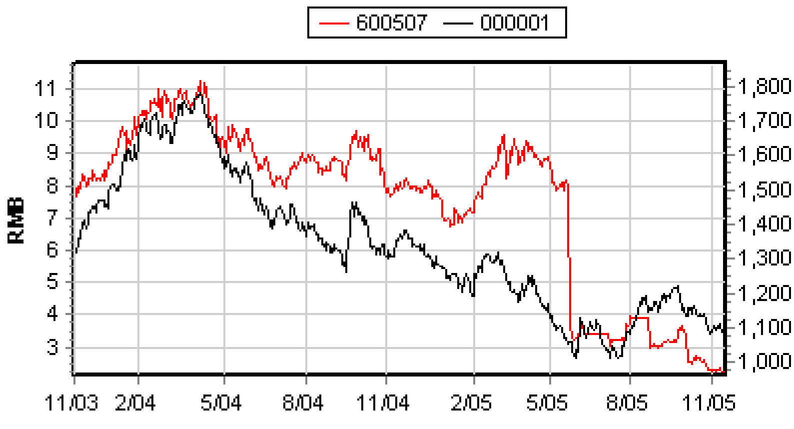
[50] Company information on Handsome Electronics from www.hgschina.com (2005-11-28)

price has pretty much stayed below or just below the Shanghai A-share index. It managed to rise slightly above the A share index around April, until it followed the Shanghai A-share index and dropped to a low in June. It did not increase with the index after this drop, but rose slightly during July and August when the share was suspended from trading. After August 18, share price decreased and stayed way below the index. It seems the market appreciated the reform at first, but then punished Handsome Electronics for participating. In November, share price hit an all time low, but then recovered slightly.

4.2.6 Jiangxi Changli Automobile Spring[51]

Total assets	13 400 million RMB
Market value	8 500 million RMB
P/E	5.7
Nontradable shares	60 percent
Stock code	Shanghai 600507

Company information: Jiangxi Changli Automobile Spring was founded on September 16 1999, and was listed on the Shanghai Stock Exchange on September 30 2003. This company belongs to Jiangxi provincial hi-tech enterprise, and is a large scale special manufacturer in automobile spring and spring steel flat. The holders of tradable shares voted on August 12 about whether or not they would participate in the reform, and 85.27 percent of the holders of tradable shares voted yes.



Comment: The case of Jiangxi Changli Automobile Spring share is extreme. Jiangxi's share clearly outperformed the index until June 2005, when the share was suspended from trading and dropped from around 8 RMB per share to a little over 3 RMB per share. This is a clear

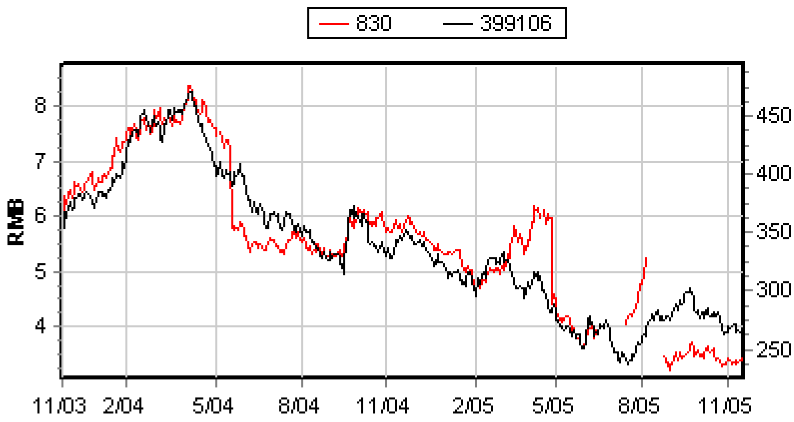
[51] Company information on Jianxi Changli Automobile Spring obtained from http://www.clqcth.com/en.htm (2005-12-01)

indicator of the market punishing the share for participating in the reform and not believing it will benefit the company. The share price stayed low until August 2005, when it climbed but not enough to catch up with the Shanghai A-share index. It dropped in September, rose slightly after that and then dropped again. In November 2005, the share price hit a low of around 2 RMB per share.

4.2.7 Shandong Luxi Chemicals[52]

Total assets	30 900 million RMB
Market value	16 100 million RMB
P/E	10.5
Nontradable shares	71.2 percent
Stock code	Shenzhen 000830

Company information: Shandong Luxi Chemicals is listed on the Shenzhen stock exchange, and went public on 7 August, 1998, with 50 million stocks of fixed price, including 5 million stocks sold to employees. The company's main products are urea and fertilizers, and it is regarded as a national advanced technology improvement unit by China Economic&Trade Committee. In the future, the company will base on fertilizers to develop fine chemical products and turn it into large-scale production.



Comment: Shandong Luxi Chemicals has followed the Shenzhen index pretty well. It did not react in particular to the announcement that the company was chosen to participate in the reform. Around this time, 20 June, share value hovered around the index. After July, share price rose, way above he Shenzhen index, and this implies the market approved the compensation plan and believed in it. Although share prices have fallen since, so has the index and it looks as if Shandong Luxi Chemicals will have a chance to catch up with the index in the future.

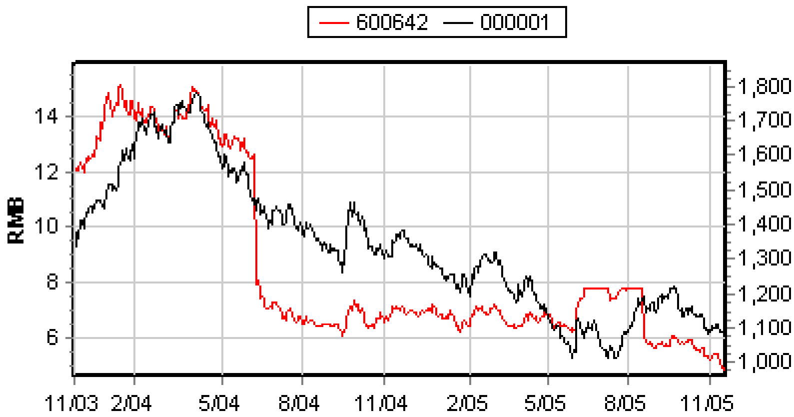
[52] Company information on Shandong Luxi Chemicals obtained from http://english.lxhg.com/xsqy0.asp (2005-12-09)

4.2 8 Shenergy[53]

Total assets	179 500 million RMB
Market value	208 700 million RMB
P/E	18.0
Nontradable shares	77.1 percent
Stock code	Shanghai 600642

Compensation plan: Holders of tradable shares will receive 3.2 shares for every 10 tradable shares they hold**.**

Company information: Shenergy Company was listed in 1992, when Shenneng Electric Power Company was converted into Shenergy Company Ltd. This was the first listed company in the industry of electric power and energy. Shenergy invests and manages Shanghai electric power and energy projects. In the end of 1999, about 70 percent of the shares in Shenergy were state-owned and about 15 percent publicly owned. The rest of the shares were held by legal persons and therefore also non tradable. The shareholders voted in favour of the reform on August 11, when 99.3 percent of the holders of tradable share votes yes. Shenergy's share is blue chip rated and one of the leaders in the stock market.



Comments: Shenergy's share price has been way below the index since June 2004, but in July 2005 it increased indicating the market had a positive outlook on Shenergy participating in the reform. The market considered the privatization of Shenergy as positive, contributing to share prices rising significantly and outperforming the index. Share value succeeded in staying high and above the index until sometime in August, around the time shareholders

53 Company information on Shenergy obtained from www.shenergy.com.cn/english/gf/jj.htm (2005-12-09 and 2005-01-16)

approved the reform, when it dropped and has not recovered. Share price reached a really low price in November 2005.

4.2.9 Shenzhen Agricultural Products Co.[54]

Total assets	41 000 million RMB
Market value	13 200 million RMB
P/E	113.3
Nontradable shares	75 percent
Stock code	Shenzhen 000061

Compensation plan: Owners of tradable shares will be given an option to sell tradable shares to the SASAC (the State-owned Assets Supervision and Administration Commission of the State Council) during the last five days of the twelfth month following the reform at a price of RMB 4.25, which is a 26.87 percent higher than the share price was before the reform.
Company information: Shenzhen Agricultural Products is a wholesale distributor and trader of agricultural products. The company was established in February 1989 and listed on the Shenzhen Stock Exchange as A shares. On August 16, the shareholders approved the reform and the company's compensation plan at the extraordinary shareholders' meeting.

Comment: SZAP share price has hovered just below the index pretty much since 2004. It hit a low in February 2005, and since then it managed to climb to index level in June which is when the company was chosen for the reform. After June, share price rose above the index meaning the market must have really believed in SZAP participating in the reform. In August, when the share holders voted in favour of the decision, SZAP share price rose. From October, SZAP share price has increased and again stayed above the index which gives a positive

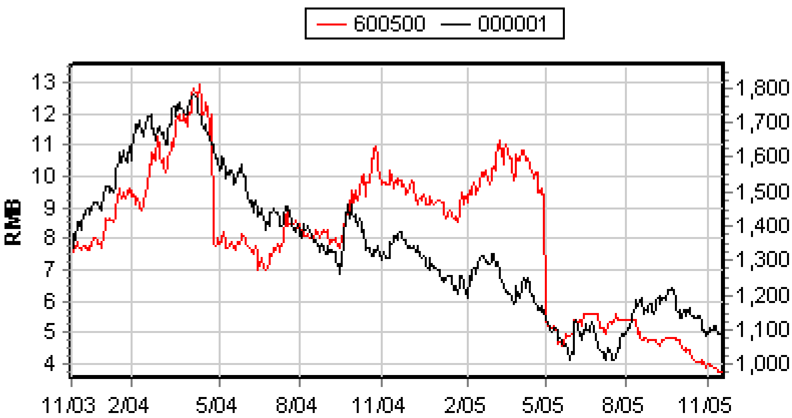
[54] Information on SASAC obtained from www.sgvege.com/gsjjen.asp (2005-12-02) and www.scrc.com.cn/en/gsjj/zykh.jsp (2005-12-02)

outlook for the future. SZAP share price is doing well since the reform, and the increase provides a positive picture for the future.

4.2.10 Sinochem International[55]

Total assets	53 300 million RMB
Market value	70 200 million RMB
P/E	5.9
Nontradable shares	67.8 percent
Stock code	Shanghai 600500

Company information: Sinochem Corporation was founded in 1950 as the first state owned import and export enterprise specializing in foreign trade business. The company started out by dealing with foreign trade with western countries, imported necessities for domestic production and thereby supported the economic development in China. The company today operates in three basic areas; fertilizers, chemicals and oil. In 2000, Sinochem became a key enterprise under direct control of the state council, and Sinochem International was listed on the Shanghai Stock Exchange in March 2000 with Sinochem as the holding company. Sinochem also managed to establish four overseas business groups in Europe, America, Asia and Hong Kong.



Comment: The first part of 2004, share prices climbed, though they were underperforming the index. In the end of April 2004, share prices dropped. By this time Sinochem was involved in a lawsuit regarding the use of its trademark by two other companies (Sinochem won the lawsuit on May 19). Since end 2004 Sinochem share price has well outperformed the index. It was at a high market value until May 2005, when it again experienced a huge drop of about RMB 4 per share. The index rose a little when Sinochem was chosen for the reform and

[55] Company information on Sinochem International obtained from www.sinochem.com (2005-12-01)

when the shareholders voted for the reform, but since then it has decreased and been at a really low value. It looks like it will continue to drop for a couple of months in the future.

4.3 The Shanghai A share index[56]

When the reform was introduced, in May, the Shanghai A-share index hovered around 1200[57]. After the introduction of the reform, the index dropped, with the lowest value being 1062.45 on July 17. However, it made a comeback and turned the negative trend around, climbing up to above 1200 in the end of August. Below, movements in the Shanghai A-share index are connected to important dates for larger companies participating in this study[58].

Significant dates and how the index reacted during the first part of the reform: May 9, when the first four companies taking part in the reform were announced, the index dropped 28.31 points. The index rose by 5 points May 10, when Sany heavy Industry released its compensation plan, although this wasn't the only reason the index climbed. Eight companies reached their daily upper limit this day which helped push the index. On May 11, Sany Heavy Industry reached its upper limit when it resumed trading after releasing their compensation plan. Zijiang Enterprises reached its upper limit on May 12 when it resumed trading indicating the market accepted the compensation plan, though a surge in blue chip rated companies such as Baosteel and CYPC kept the index low. On May 31 the CSRC and SASAC issued a 10-point proposals of the sale of the non tradable shares, which helped push the market, though not enough since investors had no confidence in the market or any funds to pour into the market. Sany Heavy Industry's share was suspended from trading from June 2, and the shareholders' meeting was held on June 13 when the A-share index dropped 2.02 points. When Sany resumed trading on June 15, the share opened reaching its daily upper limit and remained there for the rest of the day. The index kept decreasing through the beginning of June, then turned around and increased on June 8 when it gained 88.97 points due to large companies with huge trading volumes that kept funds pouring into the market. Shanghai Zijiang Enterprise had their shareholders' meeting on June 10, and the A-share index dropped 23.96 points this day.

Significant dates and how the index reacted during the second part of the reform: On June 20, when the 42 companies chosen were announced, the index dropped 4.39 points, and

[56] See appendix 1 for data on the A share indices
[57] All share price data and index data from http://www.chinastock.com.cn/english/ChinaWatch1.jsp?catname=IssuingListing (2005-11-25)
[58] Since ten out of twelve companies in the study are listed on the Shanghai stock exchange, including large blue chip rated companies, only the Shanghai index will be analyzed. However, data for the Shenzhen index is attached in appendix 1.

kept on decreasing a couple of days afterward. The first shareholder meeting out of the ten companies was that of CYPC and Citic Securities, which took place August 8. The index responded by increasing 10.65 points. CYPC is blue chip rated and affects the A share index, and an increase in the index on the day CYPC's shareholders approved the reform meant the market had a positive outlook on CYPC participating in the reform. Shenergy's shareholders approved the reform on August 11 when the index increased 19.42 points. On August 12, Baosteel and Jiangxi Changli's shareholders voted in the matter and the index then surged 16.88 points, which is of importance since Baosteel is a large blue chip rated company and affects the A-share index in the same way Shenergy and CYPS do. The fact that the index climbed when CYPC accepted the reform and dropped when Baosteel accepted could be since other large companies were doing good those specific days, and it could also be because the market believed in CYPC's compensation plan and did not believe in Baosteel's. CYPC's compensation plan said to give holders of tradable share 1.67 shares for every ten shares held plus 1.5 shares warrant for every ten shares held. Baosteel's compensation plan said to give holders of tradable shares 2.2 shares for every ten shares held plus a European call option. It does not seem CYPC's compensation plan is superior to Baosteel's, which is why the conclusion probably is that there were other factors affecting the index that day.

5. Analysis

5.1 Why share price decline

In the case of the two companies participating in the first part of the reform, share price dropped really low and way below the index after the reform had started. For both Sany Heavy Industry and Shanghai Zijiang Enterprise Group, share prices rose on the day the reform was approved by the holders of tradable shares but declined on the day trading in the bonus shares begun. The interpretation to this would be that the market liked the proposals that the owners of non tradable shares should compensate owners of tradable share. However, the fact that share prices declined sharply on the day the bonus shares started trading, could be explained by the fact that the increase in the number of tradable shares normally leads to a decrease in share value. The question is does the decline in share value equal the increase in the number of shares? On the day the bonus shares were listed for Sany Heavy Industry, share price declined 30 percent from 11.864 to 8.305 RMB per share[59]. But if we consider the bonus[60] offered to the holders of non-tradable shares, one share is now worth 1.35, so share price can be said to only have fallen to11.212 RMB per share[61], which is only 5.496 percent less than 11.864 RMB per share[62]. So far the decrease has been low, but if share value decreases a second time, when the shares are traded in the market, there probably will be complaints from the shareholders.

In the second part of the reform, share value normally increase or stabilize around the time that the shareholders vote in favour of the reform and approve the compensation plan. For eight out of ten companies in the study, share value then decrease and stay low below the index when the bonus shares start trading. Why does share value decrease a couple of months after shareholders approved the reform? The fact that share value decreases since the number of shares outstanding increase is however not a completely sufficient explanation to the sometimes really large decrease in share price. In the case of Sany Heavy Industry, there is a decrease in share price even though the natural decrease in share value when the numbers of shares increase is accounted for. Zuobao *et al* (2005)[63] measured firm value as Tobin's Q[64]

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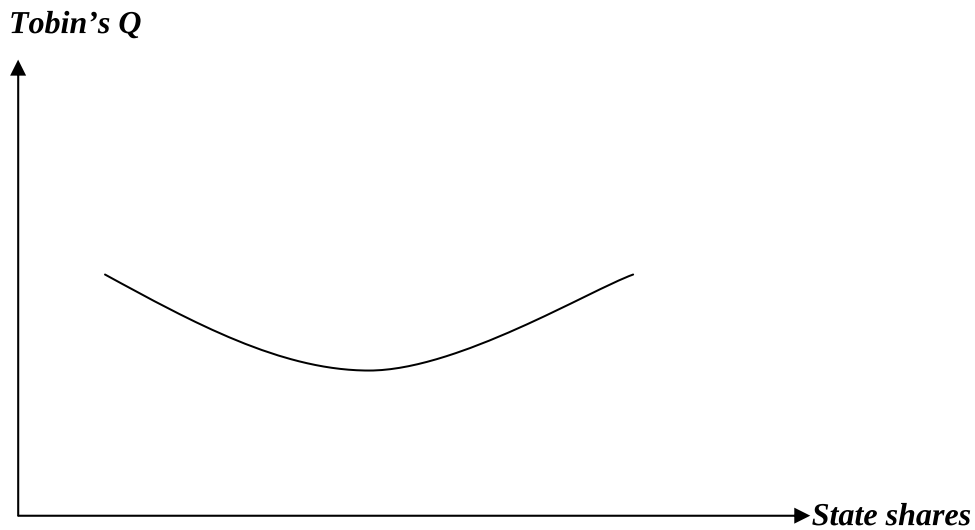
[59] The data obtained from http://www.nicmr.com/nicmr/english/report/repo/2005/2005aut04.pdf (2005-12-09)
[60] One tradable share is now worth 1.35 times the value of the share
[61] Calculation: 1.35*11.864=11.212
[62] Calculation: (11.212-11.864)/11.864=5.496
[63] *Ownership Structure and Firm Value in China's Privatized Firms: 1991-200,* Zuobao *et al*, Journal of Finance and Quantitative Analysis, 2005, vol 40:1, p 87-108
[64] Tobin's Q=sum of market value of equity and book value of debt divided by book value of assets

and test whether 5284 partially privatized, former state-owned enterprises show any significant relation between ownership structure and firm value. The mean degree of state ownership in the 5284 firms is 30.9 percent, which is lower than the degree of state ownership in this case study at 71.9 percent[65], but their results are still of importance for this study. Zuobao *et al* found that state ownership in firms is significantly negatively related to Tobin's Q, and therefore has a negative impact on market value. However they found that the relationship was convex, meaning that firm value first decreases when the degree of state ownership decreases, and then increases. A diagram is provided for illustration:



The firms included in this case study are only in the first phase of the reform and they haven't even begun the actual selling of the state-owned shares yet. They might very well be in the phase of declining share value right now, but in a couple of months, or maybe even a year from now their share value could increase, catch up to the A-share index and hopefully outperform it.

5.2 Comparing this reform to earlier reforms

In previous reforms undertaken by the government, share prices have fallen rapidly once the company starts selling state owned shares. The results have been largely unsatisfactory, and most privatization reforms that started with the market being at a peak have ended with the market declining. In 2001, the CSRC surprised the market with the news of the privatization

[65] The average degree of state ownership, calculated as the sum of degree of state ownership in the sample divided by twelve (the number of companies in the sample)

reform, and since we know now this reform was a big failure, we can jump to the conclusion that the market does not like surprises. Share price declined and investor's unwillingness to buy the shares made it difficult if not impossible to proceed without avoiding a financial disaster. This time, the CSRC kept the market better informed. When it announced the news that there would be a new reform, it did so on April 30 2005, right before a week-long holiday when the markets were closed. This would give Chinese investors a chance to digest the news. When this reform proceeds, it may very well be the case here also that share value will drop again when trading in the former non tradable shares begin, and investors will protest. Considering earlier reforms, where share value dropped really low, there is not much evidence to the contrary. This has yet to be seen though, but the government now has the advantages of:

a) having experienced earlier reforms and learned their lessons,
b) having individualized the reform so that companies can make the reform fit their structure, by allowing the companies themselves to draw up the guidelines.

So far this reform started better than the previous reforms and it has not faced blanket rejection by he market and investors. Sometimes share price increased just after the announcement was made that the company was chosen for the reform, or when share holders voted in favour of the reform[66]. The decline in the A-share indices following the beginning of the reform was followed by an increase as the shares resumed trading. Especially large blue chip companies handle privatization well, and it is a promising start that these stable, large companies are ready for privatization. Plus there is the indicator that the results are moving in the right direction, starting with privatization reforms failing big and moving towards this reform of 2005, which was welcomed by the market in some aspects and rejected in others.

5.3 Problems regarding property rights

Problems with clearly defined property rights complicate the shift from state-owned to privately owned enterprises further. In China only a small part of the property rights are normally retained by the ultimate owner, in other words the shareholders, while other rights are kept by the enterprise's legal person; for example the use of profits or dividends is mostly decided by a subsidiary instead of the parent company. Still other rights are found in the hands of government or other party agencies, like the right to select managers[67]. It is widely recognized that the state is a fictional owner, and does not have as strong an incentive and as much information as individual owners when it comes to monitoring and protecting property

[66] As was the case of for example Shenergy, Citic Securities and CYPC when the state announced the reform 20 June.
[67] *China's management of enterprise assets,* The World Bank Country Study, 1997, p22-26

rights. Normally the acting owner is someone on government level, meaning that decision making have to pass through a long bureaucracy and taking long time to come through[68]. Other stake holders in SOEs, such as workers, suppliers, banks, and customers can take advantage of this bureaucracy and exercise and monitor property rights in SOEs this way, and SOE managers are therefore enjoying more authority than they otherwise should[69]. Even though there is confusion as to defining property rights during the transfer from a SOE to a privately owned enterprise and this causes problems, once the transition of the rights is made and the state is not a block holder anymore, the company could benefit greatly from the shift of ownership and perform better. Cutting out bureaucracy to make the company more market-adapted is positive for the company, and letting the management enjoy both control and income rights could make for less expropriation of holders of income rights and better corporate governance.

5.3.1 Strong corporate governance important

If property rights have to be shifted, they will have to be properly defined and this could strengthen corporate governance, which is crucial in order for companies to proceed with the reform[70]. According to The World Bank Country Study (1997), there are a few problems as to why SOEs have troubles exercising strong corporate governance, some of them being as follows:

- The state as an owner generally has poor information about the SOE's manager's action and enterprise performance.
- In SOEs, social and commercial functions normally come together making it difficult to tell them apart and therefore figure out who is monitoring the company.
- Manager's skills are poorly adapted to a market economy.
- Outside monitors, such as banks, exercise discipline on SOEs undermining strong corporate governance.

So how can weak corporate governance be avoided? For example via ownership diversification, so that every owner has a smaller part of the company to control (only works

[68] *China's management of enterprise assets,* The World Bank Country Study, 1997, p22-26
[69] *China's management of enterprise assets,* The World Bank Country Study, 1997, p 26
[70] Bulgaria in the 1990s can serve as an example as to what happens when clear property rights are not defined. In 1991 a privatization reform was due to take place but was postponed until 1995. During these four years the state lost capacity to monitor enterprise performance, leading managers to allocate cash flows to themselves and little to the government. The governmental losses were covered by loans, leading to a bank crisis in 1995, followed by high inflation and interest rates of 300 percent (World Development Report, 1996 and Claessens and Peters, 1997).

when shareholders rights are strong and clear property rights defined), decentralized ownership (local owners have fewer monitoring problems), and listing shares on the stock exchange (via listing, shareholder rights clarify and information disclosure improves). Strong corporate governance is crucial when a company goes through a transformation and help enhance the company's chances of making the transition smooth.

5.3.2 Principal agent problem in SOEs

In a SOE, government officials hold the control rights and taxpayers hold the income rights. State control might create a principal agent problem[71] because income rights are separated from control rights, and taxpayers may be expropriated by governmental bureaucrats[72]. Taxpayers holding the income rights will want as much payoff as possible, while at the same time they cannot affect decisions regarding the business since the government holds the control rights. Owners of different rights will make their best effort only when their rights are fully recognized by rewards for participating in production[73], which explains why the government might not put full effort into making the exact right decision for the company since they will not enjoy the direct payoff from that decision.

There is also a problem of principal-agent nature when the agent is the company's management and the principal is the government. If the manager (agent) is paid by the hour and not by units of production, he may very well slack off while he is working and not care about how many units he produces since he will be paid regardless. The agent, being hired to perform a job for the principal (government) also has the advantage of insider knowledge. The principal (government) wants as much direct control as possible over the firm to avoid the scenario that the agent can benefit from information not known to the principal. China has tried to overcome the principal-agent problem by introducing rewarding systems, such as increasing profit retention rates and making the firms more self-financing[74]. However, when the government is involved in firms there is going to be a principal-agent problem. Cutting the principal out, in other words cutting out the government, means the management is no longer an agent, but transforms into the principal and the performance of the firm is now more interesting and personally rewarding. From the firm's point of view, this must be for the better considering the people in charge actually work in the firm and have access to inside

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[71] Def. principal agent: the agent, hired by the principal, maximizes his utility first and not the company or the principals'. (*Microeconomics a modern approach*, Schotter, 2001, 3rd edition, p 311)
[72] *Expropriation, regulation and firm value*, Berkman, Cole and Fu, University of Auckland, Dec 2003
[73] *China's Management of enterprise assets*, The World Bank Country Study, 1999
[74] *How China's Government and State Enterprises Partioned Property and Control Rights, Xu,* The World Bank Policy Research Department, 1997

information. In a SOE, the government is trying to gain control and access into the firm but might not always succeed, leading them to sometimes make bad decisions due to lack of information and market knowledge. Having the principal closer to the company and at a lower level must make for more accurate decisions and less time between cause and action, which are both good things for the firm. It must also cut out some bureaucracy and make the firm more market-adapted, which is the whole point of privatizing in the first place.

5.4 Changing the budget constraint

When transforming a SOE into a privately owned company one must also consider the issue of transforming a company from a soft to a hard budget constraint[75]. According to Dewatripont and Roland (1999)[76], SOEs following a soft budget constraint have caused obstacles to society since they avoid the threat of bankruptcy, prevent efficient private firms to enter the market and let government expenditures speed out of control. When firms transform into privately owned companies they must abandon the soft budget constraint and embrace a hard budget constraint. This will naturally cause “survival of the fittest” among firms, and sending some firms into bankruptcy. A sacrifice of this nature might be inevitable, though, considering many SOEs have hid behind their soft budget constraint and letting the government bail them out whenever they could not keep their initial budget. A company that has taken advantage of this for years may very well not survive market competition and be forced to close down. In the short run, this can cause tragedy and massive unemployment, which has to be dealt with especially since being employed in a SOE in China has equalled being hired for life, but in the long run new employment opportunities will come up and move the economy forward.

5.5 Is the Chinese economy ready for privatization?

Many of the investors in China live in fear that the government will cook up new ways of selling their share in state-owned companies. So far, almost all companies participating in the privatization reform have experienced a share price decline, and that should be evidence enough the market is not ready for privatization yet. However, this important step towards of selling off the state shares could be one that China must take if it is ever to enjoy the full benefits of a privatized economy. The spread of ownership in Chinese companies can

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[75] Soft budget constraint: enterprises do not face penalties for overspending, in this case SOEs receive subsidies from the government when they are not able to stick to the initial, fixed budget (Sjöberg and Gang, 1996)
Hard budget constraint: The firm is obliged to keep a fixed initial budget.

[76] *Soft budget constraints, transition and financial systems,* Dewatripont and Roland, ECARE, Université Libre de Bruxelles and CEPR, 1999.

encourage new entrepreneurs and open up the economy for small businesses. Private ownership could therefore bring political and social advantages to the country, such as new employment opportunities, new career choices and entrepreneurs that see new business opportunities and grab them. If the stock market is to allocate capital efficiently, privatization is necessary. Freeing up state-owned shares would protect minority investors by giving them a chance to vote, without the hopeless situation of being David against Goliath, and help discourage corruption in such a way that it is possible to benefit privately from an action or a decision in a company.

When the state sells off the shares, it does so by relatively small pieces at a time. This means that the state does remain in control of the company nevertheless, and still owns the largest fraction of the shares. China's leaders often take the slow approach and when the state sells off the shares, it does so by relatively small amounts at the time. While the development towards a market oriented economy is promising, it might and probably will hit more problems on the way. Government might not want to give up control easily and if share prices keep declining and hit really low values the government might feel pressured to stop the reform. It is not surprising companies participating in the reform experience share price decline, since there are so many problems to solve around the transformation of the shares. However, when these problems are worked out the transformation might in the end go smother than predicted. If not, as long as the government sticks to the original plan of including all companies in the reform, the stock market might just need some time to adjust before the reform is accepted and share price stop declining.

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Appendix 1

Data of the Shanghai and Shenzhen A share indices

	SH A-share	increase/decrease since previous trading day	SZ A share	increase/decrease since previous trading day
2005-05-09	1186.90	-28.31	3031.49	-125.18
2005-05-10	1191.90	+5.00	3131.89	+22.88
2005-05-11	1180.10	-11.29	3068.20	-63.69
2005-05-12	1158.72	-21.38	3001.03	-67.61
2005-05-13	1162.54	+3.82	2987.44	
2005-05-14				
2005-05-15				
2005-05-16	1149.91	-12.63	2948.77	-38.67
2005-05-17	1154.13	+4.22	2962.44	+13.67
2005-05-18	1157.67	+3.54	2957.54	-4.90
2005-05-19	1158.17	+0.50	2963.76	+6.22
2005-05-20	1153.78	-4.39	2964.97	+1.22
2005-05-21				
2005-05-22				
2005-05-23	1124.04	-28.42	2894.22	-70.75
2005-05-24	1127.00	+2.96	2914.47	+20.26
2005-05-25	1125.27	-1.73	2906.31	-8.16
2005-05-26	1111.28	-13.99	2878.31	-28.00
2005-05-27	1104.03	-7.25	2844.65	-33.66
2005-05-28				
2005-05-29				
2005-05-30	1112.75	+8.72	2842.95	-1.70
2005-05-31	1113.29	+0.55	2836.27	-4.68
2005-06-01	1090.64	-22.65	2755.37	-82.90
2005-06-02	1066.54	-24.10	2684.31	-71.06
2005-06-03	1063.96	-2.58	2691.2	+6.91
2005-06-				

04				
2005-06-05				
2005-06-06	1085.77	+20.74	2784.21	+92.99
2005-06-07	1082.06	-3.72	2777.47	-6.74
2005-06-08	1171.02	+88.97	3018.04	+240.57
2005-06-09	1187.39	+16.37	3036.83	+18.79
2005-06-10	1163.43	-23.96	2961.40	-75.43
2005-06-11				
2005-06-12				
2005-06-13	1161.41	-2.02	2951.18	-10.22
2005-06-14	1147.98	-13.43	2918.83	-32.35
2005-06-15	1078.84	-14.42	2799.34	-22.16
2005-06-16	1140.33	+13.99	2888.98	+34.14
2005-06-17	1140.18	-0.15	2875.30	-13.68
2005-06-18				
2005-06-19				
2005-06-20	1115.62	+30.01	2978.23	+102.93
2005-06-21	1156.71	-14.97	2943.56	-34.67
2005-06-22	1157.35	+0.64	2962.37	+18.81
2005-06-23	1148.60	-8.75	2945.15	-17.22
2005-06-24	1157.19	+8.60	2956.76	+22.61
2005-06-25				
2005-06-26				
2005-06-27	1181.08	+22.76	3026.78	+70.03
2005-06-28	1164.28	-16.05	2979.10	-47.68
2005-06-29	1160.49	-3.79	2950.09	-29.01
2005-06-30				
2005-07-01			2816.45	
2005-07-02				
2005-07-03				
2005-07-	1099.83	-8.43	2827.29	+10.84

04				
2005-07-05	1091.08	-8.75	2802.07	-25.22
2005-07-06	1085.35	-5.73	2780.72	-21.35
2005-07-07	1090.67	+5.32	2790.69	+10.00
2005-07-08	1069.13	-21.54	2738.09	-52.60
2005-07-09				
2005-07-10				
2005-07-11	1062.45	-6.68	2729.86	-8.23
2005-07-12	1098.99	+36.54	2824.28	+94.42
2005-07-13	1089.82	-9.17	2813.98	-10.30
2005-07-14	1093.26	+3.44	2821.50	+7.52
2005-07-15	1078.84	-14.42	2799.34	-22.16
2005-07-16				
2005-07-17				
2005-07-18	1064.78	-14.06	2784.48	-14.86
2005-07-19	1066.92	+2.14	2791.05	+6.58
2005-07-20	1073.97	+7.05	2823.41	+32.36
2005-07-21	1073.86	-0.11	2828.51	+5.1
2005-07-22	1100.42	+26.56	2878.60	+50.09
2005-07-23				
2005-07-24				
2005-07-25	1099.45	-0.97	2857.08	-21.52
2005-07-26	1128.12	+28.67	2936.20	+79.12
2005-07-27	1145.84	+17.72	2997.97	+61.77
2005-07-28	1142.45	-3.39	2990.49	-7.48
2005-07-29	1138.69	-3.76	2981.88	-8.61
2005-07-30				
2005-07-31				
2005-08-01	1144.83	+6.14	2982.91	+1.03
2005-08-02	1160.46	+15.63	3035.11	+52.2
2005-08-	1164.06	+3.6	3070.38	+35.27

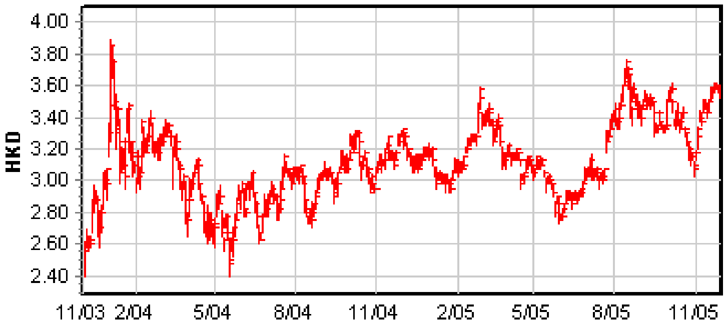
03				
2005-08-04	1158.81	-5.25	3043.59	-26.79
2005-08-05	1186.07	+27.26	3114.85	+71.26
2005-08-06				
2005-08-07				
2005-08-08	1196.72	+10.65	3130.42	+15.57
2005-08-09	1211.02	+14.3	3138.30	+7.88
2005-08-10	1224.58	+13.56	3145.30	+7.00
2005-08-11	1244.00	+19.42	3217.26	+71.96
2005-08-12	1227.12	-16.88	3138.55	-78.71
2005-08-13				
2005-08-14				
2005-08-15	1247.12	+20.00	3208.92	+70.37
2005-08-16	1236.88	-10.24	3172.53	-36.39
2005-08-17	1253.37	+16.49	3193.89	+21.36
2005-08-18	1206.29	-47.08	3091.43	-102.46
2005-08-19	1208.56	+2.27	3095.05	+3.62
2005-08-20				
2005-08-21				
2005-08-22	1217.56	+9.00	3125.20	+30.15
2005-08-23	1208.53	-9.03	3100.83	-24.37
2005-08-24	1226.56	+18.03	3107.12	+6.29
2005-08-25	1232.14	+5.58	3097.38	-9.74
2005-08-26	1231.76	-0.38	3085.66	-11.72
2005-08-27				
2005-08-28				
2005-08-29	1213.55	-18.21	3046.88	-38.78
2005-08-30	1205.08	-8.47	3041.87	-5.01
2005-08-31	1222.16	+17.08	3078.91	+37.04

Appendix 2

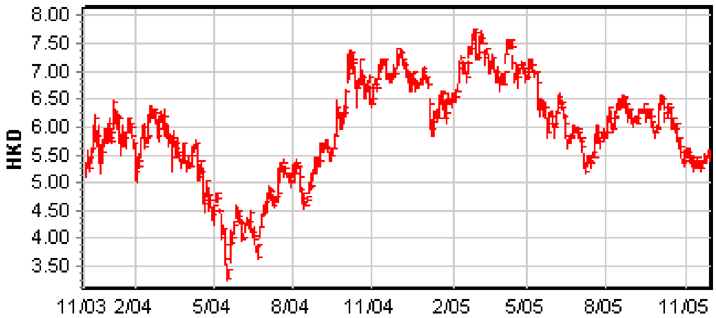
Chinese companies listed on the Hong Kong Stock Exchange who managed to increase share value since 2003, despite the country's bearish market.

China Oilfield Services Ltd. - H Shares Stock code: 2883

China Petroleum and Chemical Corporation, Stock code: 386

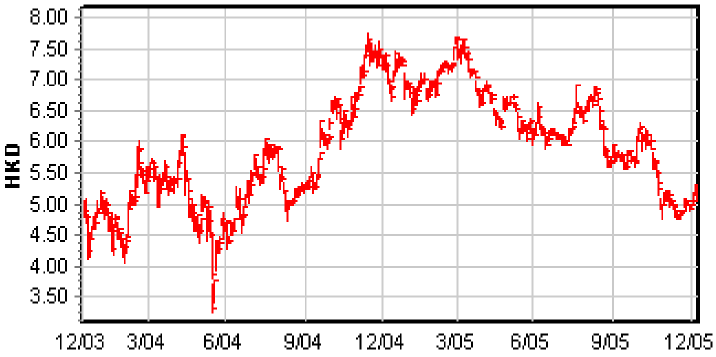


China Shipping Development Co. Ltd. - H Shares Stock code: 1138



PetroChina Co. Ltd. - H Shares, Stock code: 857

Also Yanzhou Coal Mining Co. Ltd. - H Shares, Stock code: 1171



Zijin Mining Group Co., Ltd. - H Shares, Stock code: 2899