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Monitoring state-owned versus state-controlled enterprises

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China's growing number of market-oriented state-owned enterprises (SOEs) has drummed up much interest, especially in the ways the performance of these entities - legacies of China's command economy - are measured. More and more of these companies are tapping the capital markets for funds, adding heft and strength to stock markets in China and beyond.

So what actually helps improve numbers at a Chinese listed company? One of the keys to the puzzle is that state-owned enterprises consistently outperform listed Chinese firms that are controlled by government agencies.

This is baffling because both SOEs and government agencies share the same ultimate shareholder: the Chinese government. Nonetheless, investors clearly perceive both entities differently as reflected by their positive reaction to block share transfers from government agencies to SOEs.

In his research paper titled, "A Comparison of Shareholder Identity and Governance Mechanisms in the Monitoring of CEOs of Listed Companies in China," Wang Jiwei (http://www.accountancy.smu.edu.sg/faculty/accounting/jwwang.asp), a practice assistant professor at SMU's School of Accountancy (http://www.accountancy.smu.edu.sg/index.asp), argues that shareholder identity plays a far bigger role in determining whether a company performs than corporate governance reform.

Over the past few years, the Chinese government has attempted to monitor its listed companies via two means. The first way was to shift ownership of state shares from the bureaucratic government agencies to their more market-oriented peers, the SOEs. The second way was to strengthen corporate governance norms through statutory regulations and guidelines.

The first measure was largely successful. As Wang illustrates, SOEs are more adept at monitoring a firm's performance, in contrast to their lumbering counterparts -- the government agencies.

The second measure was met with limited success. While in the US, there are vigilante watchdogs such as the Securities and Exchange Commission, activist shareholders and boards that wield enough clout to oust a CEO, the same cannot be said of China.

SOEs vs. government agencies

So why do SOEs outperform companies controlled by government agencies? Since the government is the ultimate holder of the state shares held by SOEs and government agencies, it would suggest that the performances of both types of companies should be roughly similar.

Government agencies include central government ministries and commissions (such as the Ministry of Water Resources), local government bureaus, national industrial companies (such as the China State Shipbuilding Corporation) and local state asset management companies. By Wang's definition, all other quasi government shareholders are classified as SOEs.

While both types of shares are ultimately held by the government, there are key differences between the way an SOE is treated and the way a government agency is treated, which explains the underperformance of the latter.

SOEs are more empowered and have greater autonomy. For instance, the Chinese government has decreed that anyone who obstructs an SOE manager in the execution of his duties shall be penalised by the authorities and can be subject to criminal prosecution.

SOEs are more corporatised and are run on a merit-based system, where managers are given sufficient incentives to do a good job through monetary rewards. Take the example of First Department Store Group Company (which has been renamed as the Bailian Group (http://www.bailiangroup.cn/)), a Shanghai-based retailer and an SOE. The company pays its managers a base salary plus an incentive pay, based on a number of performance metrics, such as return on assets.

This system represents a stark contrast with companies controlled by government agencies, where top executives are promoted based on how well they execute the government's instructions and toe the party line.

It is also not the entrepreneurial prowess or the ability to steer the company towards profitability that helps a manager get ahead at a government agency controlled firm. Instead, such firms encourage rule followers. In addition, top executives at government agency-controlled companies often possess little or no industry specific knowledge.

Another crucial difference between an SOE and a government agency-controlled company is that SOEs have the right to retain dividend income, which can then be used to subsidise their non-listed unprofitable subsidiaries. This incentivises them to be profitable. In contrast, all the dividends paid by the listed companies to the government agency shareholders go into the coffers of the Ministry of Finance.

Not performing? You're gone

In his research, Wang culls market data to prove empirically that top executive turnover is more sensitive to performance at an SOE than at a government agency-controlled firm. The market-oriented SOEs appear to have more incentives to replace top managers who fail to perform than do government agencies. By virtue of this fact alone, SOEs stand to perform better.

The study is based on a sample of 841 changes of general managers at 723 listed companies from 2000 to 2005. To focus on the monitoring role of shareholders, changes in managers that were not initiated by shareholders were excluded. This included turnover due to retirement, health reasons or illegal operations.

The sample showed that top executive turnover at an SOE-controlled company is significantly higher when performance, as measured by the return on assets relative to the industry, is low. Conversely, turnover is lower when return on assets relative to the industry is high (in other words, the company is performing well).

In contrast, top executive turnover at government agency-controlled companies do not display such sensitivity to performance. Indeed, there is no significant difference in turnover for either the best or worst quintile.

However, when the yardstick to measure performance is changed to a return on assets relative to past performance or stock performance, there is no significant correlation between poor performance and management turnover at SOEs or government agency-controlled firms.

Why is that the case? Shouldn't the top management at SOEs be sensitive to poor stock performance? One explanation could be that shares held by SOEs and government agencies often cannot be traded, which makes it less of a major determinant in deciding if a manager should stay or be fired. It is also possible that Chinese boards put more weight on a return on assets, relative to industry peers, than to past performance.

Reform: No great leap forward

Although the Chinese government has also taken concretes steps to improve governance of its listed firms in general, it has not quite been the great leap forward yet.

In 2001, the China Securities Regulatory Commission (CSRC) issued a code of corporate governance for listed companies, which outlined conduct and moral standards for directors and boards of listed companies.

It introduced the concept of an independent director and stipulated that by June 2003, at least one-third of the board of all listed firms must consist of independent directors. It also discouraged combining the positions of chairperson and general manager.

These measures were successful – in the sense that companies complied with the regulations. According to Wang's study, firms with combined titles of board chair and general manager declined from 28.35% in 1999 to 23.47% in 2000. By 2004, it had further dropped to 20.32%.

Meanwhile, the number of companies that had appointed at least one independent director increased from 3.77% in 1999, to 8.49% and 28.52% in 2000 and 2001 respectively. That percentage boasted an impressive jump to 97.65% in 2002, six months before the stipulated deadline.

Although the government's targets were officially met, these measures had little impact on the performance of companies. In contrast to the US, where non-executive directors often play a vigilante role and are a significant force to be reckoned with, many non-executive directors in China do not play a similar, active role, or, conform to the company's management. In his paper, Wang noted that "many non-executive directors in China are appointed by controlling shareholders and their independence from the management is not certain."

Adding to the confusion, the CSRC's guidelines did not clearly spell out the duties of independent directors, which made it easy for loopholes to be exploited. "The CSRC 2001 guidelines requires that independent directors have a duty of good faith and diligence, but the legal meanings of these terms are so vague that it is far from clear if shareholders could successfully sue for a breach," wrote Wang in his paper.

Crucially, the effectiveness of governance mechanisms needs the support of various established institutions

(including accountants, investment banks, regulators and courts) to uphold standards, but many of these institutions are simply lacking or still at nascent stages of development in China

The way forward

What implications does the study have for the Chinese government? While China has a rapidly growing private sector, the government controls more than two-thirds of the listed companies, either through the government agencies or state-owned enterprises.

In the name of economic and market restructuring, the Chinese government has been looking at how best to dispose of a large number of shares under its control. The findings suggest that the shareholdings of the government agencies should be released first in any future sell-downs.

The government could also transfer more shares from the government agencies to SOEs. However, over the past two decades, SOEs have already gained control of most listed companies. The percentage of firms held by government agencies has fallen to the single digits as of 2004, leaving not much room for further share transfers from government agencies to the SOEs.

Another way to improve performance could be to allow the trading of non-tradeable shares and to introduce more equity-based incentives to general managers. Shares held by SOEs and government agencies have been restricted from trading, though gradually since June 2006, they have been allowed to trade on the stock exchanges – perhaps a move in the right direction.

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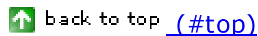 (#top)

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