State-owned Enterprise

The Story So Far

Reforming state-owned enterprises (SOEs) is critical to improve the competitive environment within China's economy and in overseas markets where Chinese firms are engaged in trade and investment. Unlike other commercial entities, SOEs are tasked with economic and political objectives. The crux of SOE reform is delineating and separating these commercial and political activities.

During the 1990s, Beijing tried to reform the state sector by consolidating state control over large SOEs while withdrawing from small ones, which contributed to private sector prosperity and a decade of strong economic growth. In the 2000s, Beijing redefined SOE "reform" as concentrating state control over key and pillar industries with strategic linkages to China's economic development and national security.

In 2013, the Third Plenum further clarified SOE reform as transforming SOEs into modern corporations, with the state exercising influence in the same fashion as other shareholders. The Third Plenum also envisioned that the state would reduce control of commercial SOEs while pushing SOEs in strategic industries to focus on their "core" business areas.

- Starting in 2014, Beijing tried to improve SOEs' competitiveness using ad hoc measures, such as mergers and mixed ownership programs (similar to those used in the 1990s) involving the sale of minority shares to private firms. These piecemeal efforts continue today. However, none of these measures has been sufficient to reshape SOEs' incentives in line with market principles or redefine their role within the economy.

- In September 2015, the State Council published a new set of "guiding principles" for SOE reform. The document was more conservative than expected. Rather than allowing the market to decide the future of SOEs, the State Council proposed utilizing market mechanisms to make SOEs bigger, stronger, and more efficient, while maintaining control by the government.

- The 2015 guiding principles reiterated a 2013 Third Plenum goal to transform the government's role in managing SOEs from "managing assets" to "managing capital." The plan was to allocate state capital toward strategic industries and reduce direct intervention within SOEs' day-to-day operations, thereby improving efficiency. The government also stated that it would strengthen SOE corporate governance but made clear that it viewed Communist Party supervision as critically important.

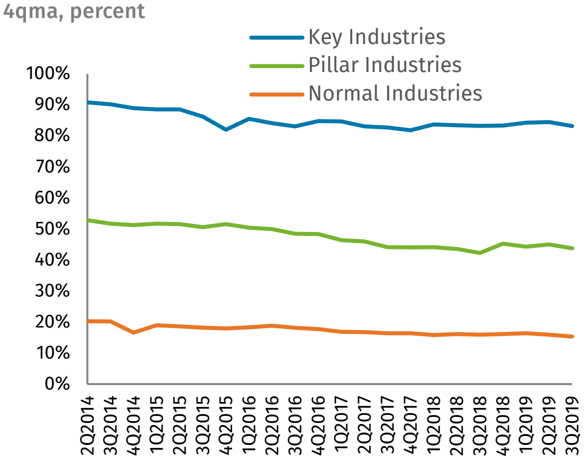
- Since 2017, the government has pushed to "corporatize" SOEs, including establishing boards of directors to replicate the structures of other commercial entities. But it also required all SOEs to institutionalize the role of Communist Party committees into their articles of association and give the Party oversight for all strategic decisions. As a result, boards of directors still lack de facto authority to manage SOE operations.

Methodology

We use China's own classification scheme to assess SOE reform progress. When information is available for listed companies, we gauge SOE revenue relative to all revenue in three clusters: (1) key industries (defense, electricity, oil & gas, telecom, coal, shipping, aviation, and rail); (2) pillar industries (autos, chemicals, construction, electronics, equipment manufacturing, nonferrous metals, prospecting, steel, and technology); and (3) normal industries (tourism, real estate, general manufacturing, agriculture, pharmaceuticals, investment, professional services, and general trade). As SOE reforms are implemented, the state firms' share of revenue should at a minimum decline in normal industries – those that Beijing has identified as suitable to market competition as the decisive factor. To supplement this primary indicator, we look at the share of all industrial assets held by SOEs, leverage ratios at state versus private firms, SOE versus private returns on assets, SOE versus private ability to cover interest payments, and the SOE share of urban employment.

Quarterly Assessment and Outlook

Primary Indicator: Share of SOE Revenues in Different Industry Categories
4qma, percent



Source: Bloomberg, Rhodium Group.

- We upgrade our assessment slightly because state firms accounted for a smaller share of listed firms' revenue and industrial firms' assets this quarter.

- However, the change was driven by better performance among private firms and a one-off reclassification of assets to reflect mixed ownership changes over the past few years. The overall pace of reform remains much slower than that in the early 2000s, and improvement seen this quarter is not sustainable.

- Policy developments remain conflicting. Beijing ordered state-owned enterprises (SOEs) to adopt additional commercial objectives but tightened Party control over them, while promising the private sector a fairer competitive environment.

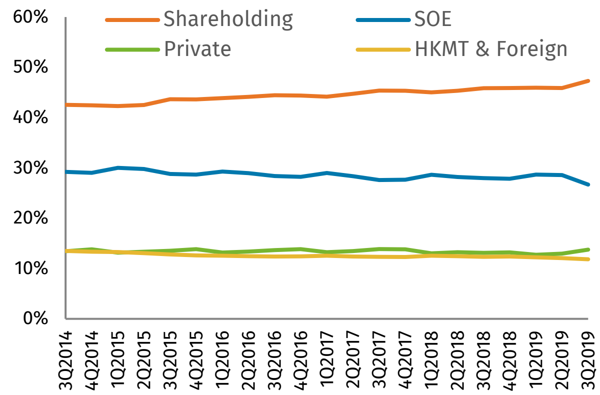
This Quarter's numbers

State presence in the economy as measured by the share of listed company revenue shrank slightly this quarter as state firms saw slower income growth than private firms. Among listed firms, the SOE share of revenue declined not only in "normal" industries that Beijing identified as non-strategic and pledged to withdraw state influence but also in "pillar" and "key" industries considered strategic to China's economic development and national security. As of 3Q2019, SOE revenue shares in normal, pillar, and key industries fell to 15.3%, 43.8%, and 83.2%, respectively, from 15.9%, 45.0%, and 84.5% in 2Q2019.

Private firms in the industrial sector also saw improved profitability. Returns on private company assets rose to 7.3% in 3Q2019 from 6.8% in 2Q2019, while those of SOEs continued to deteriorate to 3.6% in 3Q2019 from 3.9% in 2Q2019 (see **SOE Return on Assets**). Similarly, private firm capacity to service debt improved, shown by an increase in firms' interest coverage ratio to 7.9 in 3Q2019 from 7.7 in 2Q2019, while SOEs' interest coverage ratio dropped to 4.0 in 3Q2019 from 4.3 in 2Q2019 (see **SOE Interest Coverage Ratio**). In other words, Beijing's efforts to improve SOE efficiency have not succeeded.

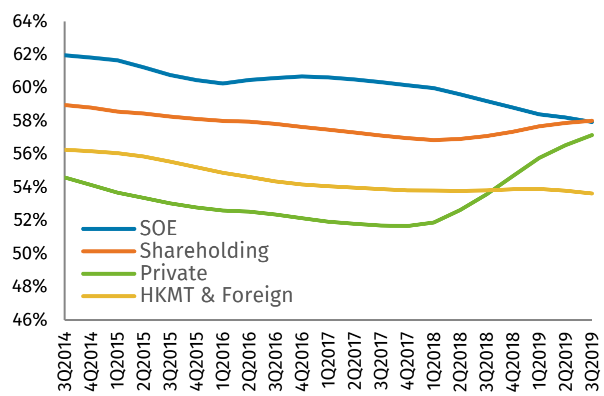
Not only did private firms outperform state firms this quarter – their slice of China's economy also expanded. Official data show a significant uptick in private firm asset growth in August (13.1% year-on-year, from 5.2% in July) and a corresponding decline of SOE asset growth (−2.6% in August from 5.6% in July). As a result, private assets accounted for 13.8% of total industrial assets in 3Q2019, up from 13.0% in 2Q2019, while the SOE asset share decreased to 26.7% in 3Q2019 from 28.6% in 2Q2019 (see **Industrial Assets by Ownership**). However, the 3.7 trillion yuan ($530 billion) decline in SOE assets from July to August is too sharp for a single month and likely reflects a reclassification of SOEs to private and other types of firms to account for cumulative reform efforts over the past few years, including the latest mixed ownership reforms (see **Fall 2019 Edition**). If so, that means the share of SOE assets has only decreased by 3% in five years – much slower than the 4% *per* year in the early 2000s – despite enormous progress claimed by officials.

Supplemental 1: Industrial Assets by Ownership
Percent



Source: Source: National Bureau of Statistics, Rhodium Group.

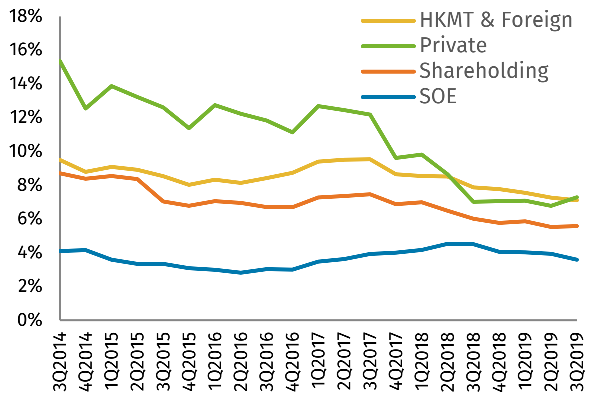
Supplemental 2: SOE Leverage
12mma, percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 3: Return on Assets

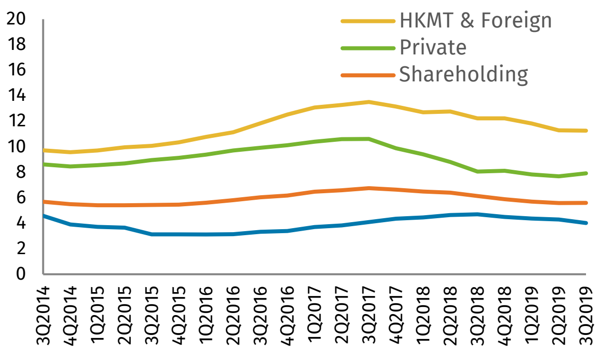
Percent



Source: National Bureau of Statistics, Rhodium Group.

Supplemental 4: SOE Interest Coverage Ratio

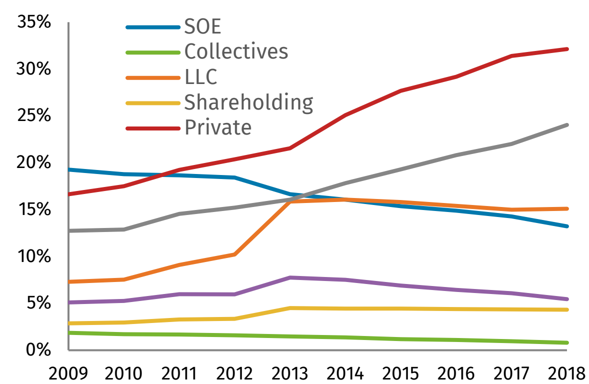
Profit to interest ratio, 12mma



Source: Bloomberg, Rhodium Group.

Supplemental 5: SOE Share of Employment

Percent



Source: Ministry of Human Resources and Social Security, Rhodium Group.

Policy Analysis

Recent policies offer conflicting signals: Beijing again ordered SOEs to adopt additional commercial objectives but tightened control over their operations at the same time. At a November meeting of the SOE reform small leading group, Vice Premier Liu He announced the development of a three-year action plan (2020–2022) to improve SOE productivity, strengthen innovation capacity, tighten budget constraints, reduce subsidies, and increase returns on state capital through measures like mixed ownership reform. In December, the State-Owned Assets Supervision and Administration Commission (SASAC) added improved profit margins, lower leverage ratios, and strong research and development (R&D) expenditures into performance evaluations for central SOE leaders. These efforts suggest that Beijing is focused on making SOEs financially sustainable.

But these measures appear no different from those pursued in previous years, which as our indicators show have only delivered minimal and in some cases negative results. The lack of progress is at least partially due to tighter control over SOEs under the anti-corruption campaign (see **Summer 2019 Edition**) and Party-building initiatives (see **Fall 2019 Edition**), which have limited SOE leaders' ability to react to market dynamics.

Those constraints will continue to obstruct reform, as Beijing tightened Party control over SOEs in late 2019. In November, President Xi chaired a Politburo meeting and discussed an ordinance detailing the Party's SOE work. The ordinance, which was publicly released on January 6, declared that the Party will continue to appoint SOE leaders (a decades-long practice), review "important" proposals before the board of directors (codified in SOE governance since 2017, with significant room for each SOE Party cell to decide what constitutes "important"), and appoint a dedicated person to oversee SOE Party building (in practice since early 2017). More importantly, while stressing that the Party cells should focus on political matters, the ordinance requires Party building to be "deeply integrated" with SOE production and operation and evaluated against SOE "reform and development progress." These objectives are not clearly defined but likely indicate SOE compliance with central policies, including the newly added commercial objectives.

Even as state firms see more political control, Beijing is assuring private firms that the government will provide a fair competitive environment for all. The State Council laid out its private sector support plan in December. In addition to promising more market access and cleaning up unfair policies, the State Council urged government bodies and SOEs to speed up the processing of accounts payable to private firms, which totaled 890 billion yuan ($130 billion) at the end of 2019 according to the Ministry of Industry and Information Technology. From private firms' perspective, these delayed payments are worse than formal trade credits to SOEs because they are usually non–interest bearing and subject to renegotiation and uncertainty between parties. The plan also commits to improving legal protections for private enterprises, entrepreneurs, and their properties. To realize these promises, the State Council emphasized that officials in breach of contracts with private firms will be punished and the government will need to compensate private firms for any losses according to relevant laws.

These enforcement commitments do look serious and feasible, as the Party is increasingly active in disciplining government bodies and SOEs. The announced restructuring of oil and gas SOEs to improve market access for private firms in December is an illustrative test case for evaluating recent efforts. But hitting these narrow objectives does not necessarily lead to a fairer competitive environment when the Party or the government still retains ultimate power to favor certain firms over others. More needs to be done to demonstrate that private and foreign firms will be treated equally with SOEs.