## 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

- We slightly upgrade our assessment of state-owned enterprise (SOE) reform from 4Q2019, but on net it remains negative. SOEs took a smaller share of revenue and assets in 1Q2020 as private firms navigated the pandemic better; however, an acceleration in SOE investment points to their larger role in the future.

- Private firms outperformed SOEs across all our indicators in 1Q2020. After a weak first quarter, private firms have rebounded in 2Q2020, whereas SOEs are still losing revenue.

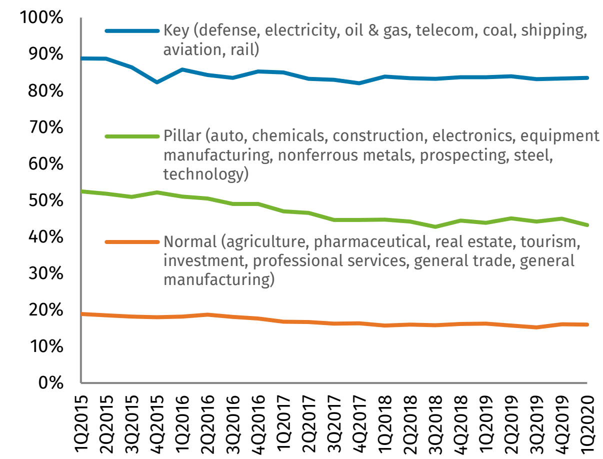
- Rather than reducing SOEs' influence, Beijing is utilizing them more strategically amid COVID-19. Authorities have tasked SOEs with increasing profit, investing more in strategic sectors, and helping secure supply chains for domestic firms.

## This Quarter's Numbers

In the first quarter of 2020, Beijing leaned heavily on SOEs to respond to COVID-19 and kick-start economic activity, but this has not yet translated into a bigger SOE presence in the economy. Among all listed firms, SOEs saw revenues fall 14% year-on-year (yoy) in 1Q2020, while private firm revenues declined by 10%.

### Primary Indicator: Share of SOE Revenues in Different Industry Categories

4qma, percent




Source: Bloomberg, Rhodium Group.

Our primary indicator gauges how revenues for listed state and private firm compare across industries. In "key" industries, where the state plays a dominant role for national security reasons, SOE presence increased slightly (see **The State's Share**). But in "pillar" industries that Beijing considers strategic for China's economic development, SOEs accounted for a smaller share of revenues. In "normal" industries where Beijing has promised to withdraw state influence, SOEs maintained roughly the same share relative to private firms.

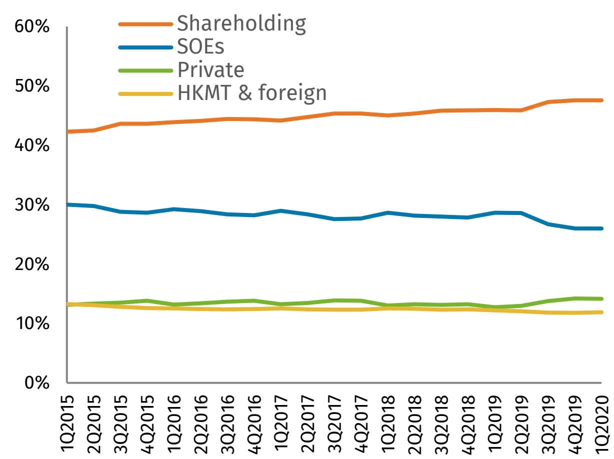
Among unlisted industrial firms, SOEs also underperformed private firms. Unlisted SOEs saw revenues fall 13% yoy in 1Q2020, a steeper decline than the 10% loss for unlisted private firms. SOEs continued to lose revenue in April and May while private firms' revenues have rebounded. In terms of profit, SOE performance was even worse: profits shrank by 16% yoy in May as private profit grew by 8%. State firms also accounted for a smaller share of industrial assets in 1Q2020 (see **Industrial Assets by Ownership**).

The overall improvement of these indicators is partially related to advancements in SOE reform made in 2019. In the **Spring** and **Winter 2020** editions, we found that the State-owned Assets Supervision and Administration Commission (SASAC), the owner and regulator of SOEs, had restructured more than 100 SOEs since August 2018, leading to their reclassification as private firms, thereby reducing reported SOE assets in 2019 and 2020.

The improvements recorded during the first quarter of 2020 do not mean that private firms are enjoying fair and equal treatment relative to state firms. Quite the opposite: authorities are counting on SOEs to lead China's recovery. While SOE investment fell 12.8% yoy in 1Q2020, it increased by 9.7% in 2Q2020. By comparison, private investment fell 18.8% in 1Q2020 and declined by another 5.7% in 2Q2020. According to SASAC, central SOE investment has risen every month since March. These investments may not have been reflected in SOE asset growth so far (they can simply reclassify assets from cash to investment if the initial amount is paid out of pocket), but they will be recognized as such eventually and contribute to an even more expansive state sector.

### Supplemental 1: Industrial Assets by Ownership

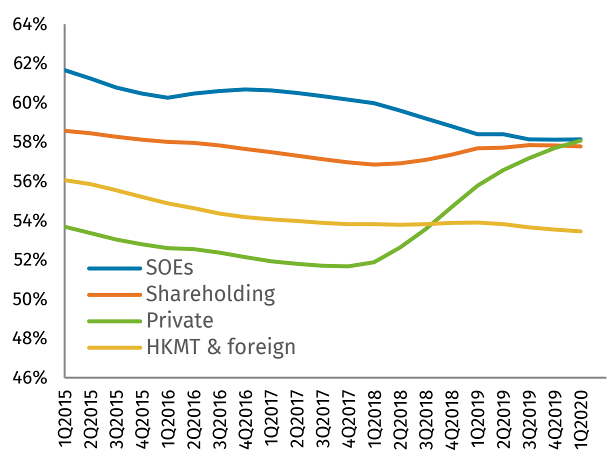
Percent




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

### Supplemental 2: SOE Leverage

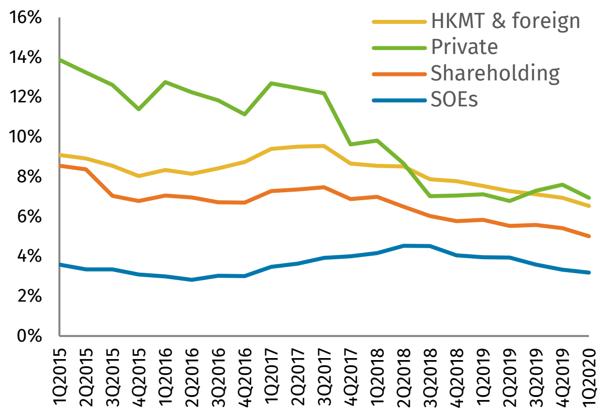
12mma, percent




Source: National Bureau of Statistics, Rhodium Group.

**Supplemental 3: Return on Assets**

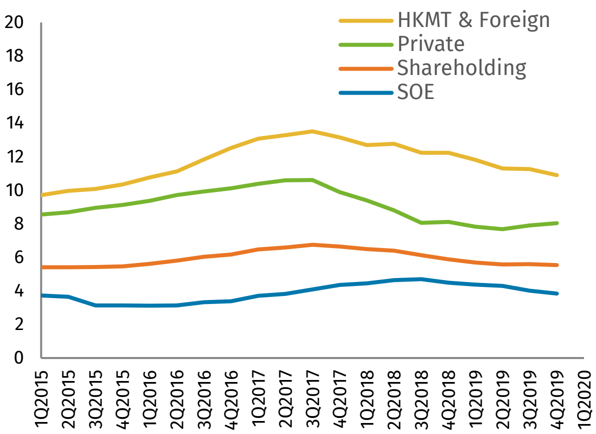
Percent




Source: National Bureau of Statistics, Rhodium Group.

**Supplemental 4: SOE Interest Coverage Ratio**

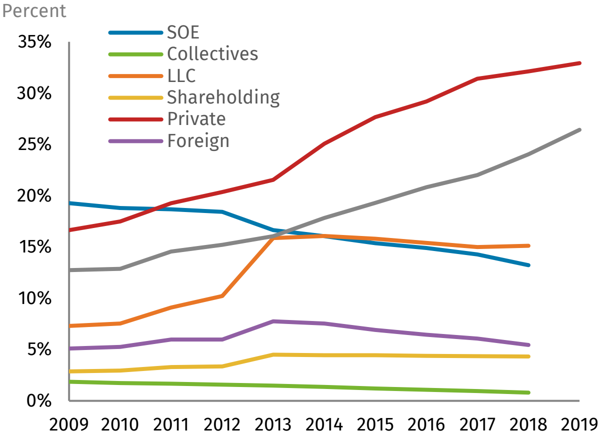
Profit to interest ratio, 12mma




Source: Bloomberg, Rhodium Group.

**Supplemental 5: SOE Share of Employment**

Percent




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

## Policy Analysis

Beijing sent three main signals on SOE reform in the first half of 2020. First, it tasked SOEs with preventing disruption of domestic company supply chains. Second, it instructed SOEs to improve profitability. And third, it told SOEs to reallocate capital from sunset industries to strategic industries. Rather than reducing their influence in the economy, Beijing is trying to utilize SOEs more effectively.

Beijing has called on SOEs to protect critical supply chains. On April 20, SASAC promised in its first quarter press conference that central SOEs would play a key role in maintaining the stability and competitiveness of domestic company supply chains and in strengthening international cooperation to ensure access to global supply chains. On April 22, President Xi visited a Shaanxi provincial automobile SOE and urged state firms to help out private firms across auto manufacturing supply chains. In practice, SOEs were required to resume work as early as possible to fulfill downstream orders, create new demand for upstream products, and provide liquidity to their customers and vendors.

While SOEs shouldered extra costs associated with Beijing's political orders, they were still expected to increase profits. On May 18, the Party and the State Council jointly published an opinion ("Guidance on Speeding Up the Improvement of the Socialist Market Economic System in the New Era"). The document proposed that commercial SOEs sell assets in capital markets as a measure to improve the allocation of state capital and increase returns. It even introduced the idea that the state might convert some of its shareholdings in SOEs to preferred shares. Holders of preferred shares are guaranteed a stable dividend payout but have no voting rights. If the plan proceeds, it would encourage SOEs to act more like commercial entities.

Finally, SOEs were told to invest more in strategic sectors. On June 30, the Central Deepening Reform Commission passed a three-year action plan for SOEs (2020–2022). SASAC started developing the plan in November 2019 and is slated to finish it by October 2020. While the full text of the plan is not yet publicly available, the meeting's readout signals that Beijing has no intention of reducing state influence over the economy. Instead, the main theme of the plan appears to be strengthening the Party's role within SOEs; reallocating state capital toward strategic sectors; and improving SOE competitiveness, innovation capacity, control, influence, and risk resistance. The plan mirrors President Xi's rhetoric at the Fourth Plenum last November devoted to Party affairs. It is difficult to square these signals with the April and May guidance on letting the market play a more important role in allocating resources. An incoherent roadmap for SOE reform ultimately darkens the reform outlook.