NATIXIS

CHINA HOT TOPICS

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SOE REFORM IN CHINA: LOUD THUNDER, SMALL RAINDROPS

On July 26th 2016, the State Council finally issued a piece of guidance on SOE reform, which focuses on those under the central government (SASAC).

SOE reform is long overdue and is becoming increasingly necessary which explains investors' anxiety to understand how real the newly announced measures may be.

Our take is that the new measures do not ensure that China's SOEs – at least not under central SASAC – will improve their efficiency, neither will moral hazard be reduced.

The reason for our negative view on the reform is that **it is not "Darwinian" enough**, i.e. it does not incorporate enough sticks and too many carrots to change the behavior of SOEs. In fact, the new rules do not contemplate a clean-up of central SASAC SOEs except in two specific sectors (steel and coal).

Given the importance of SOE reform, one wonders why the Chinese government continues to drag its feet. The reason is simple: it would be too disruptive as assets, even more so liabilities, of SOEs are increasingly larger than those of the private sector.

Here are some market-related takeaways from this disappointing reform:

- First, liquidity will continue to be needed, especially for overcapacity industries, which are many more than those addressed in the State Council guidance (steel and coal). **We should, thus, expect lax monetary policy to continue and probably deepen.**
- Second, **the absence of defaults should keep corporate spreads (especially central SASAC ones) low**, even if leverage continues to pile up.
- Third, **the consolidation process, through mergers, will continue** so we should expect increasingly larger-sized SOEs in China. Given that these mergers will be politically driven, efficiency gains will be hard to achieve, if not the contrary as the companies will be much harder to manage. **As SOEs become even larger, the risk of crowding out the private sector only increases.**
- All in all, **we should not expect the return on assets to increase in China any time soon, which brings a downward bias to potential growth.**

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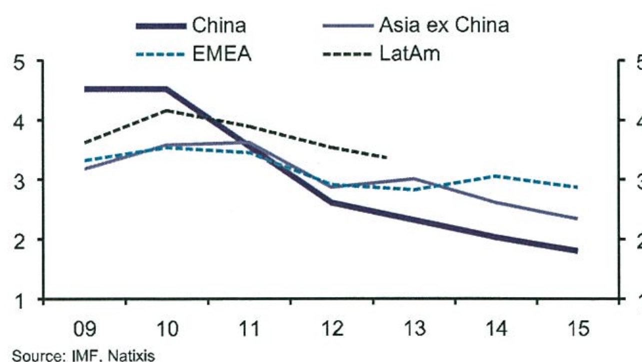
Our take on the long-awaited guidelines to reform of central SASAC

For decades, China has been through remarkable transformation but tough reforms have become more rare, especially after the global financial crisis. Among the many reforms announced since Xi's administration took office in March 2013, the most relevant ones is no doubt the reform of state-owned enterprises (SOEs). Chinese leaders have emphasized repeatedly their ambition in restructuring giant SOEs, which are known for their low efficiency, heavily indebted capital structure and poor corporate governance. The return on asset in China has been decreasing over the last few years and is now lower than most emerging countries, which can only reduce China's potential growth unless action is taken.

Chart 1
China and Emerging Market Economies: Return on Assets (%, median)



Source: IMF, Natixis

While long overdue – the first announcement of reform came during the Party's Plenum in November 2013, investors still have high expectations of a big SOE reform. Since then, small – and fragmented – measures have been announced without major consequences in terms of SOE behavior or credit risk. On July 26th 2016, the State Council finally issued a piece of guidance on central SOE (SASAC) reform. The aim is to classify **SOEs under four possible groups, according to their sectors, and clarify what may be the way forward for each of those groups by 2020.**

Although it is nice to know that **SOE diversity** is going to enter the equation, **we are not so convinced that such diversity really means a Darwinian cleanup of the SOE universe where non-viable ones will not be supported further.** The reasons for our doubt lie in the details of the sector classification and their respective ways forward. **Table 1** shows that companies can be classified in four different ways: a) **strategic** and thus "untouchable"; b) **innovative**, which is also "untouchable" with a twist that private investment is encouraged, but clearly not without control; c) **consolidation** in creating larger and thus more oligopolistic SOEs; and d) **cleanup.**

SOE reform, in our Darwinian interpretation, boils down only to the last group, which has been narrowly identified as the two overcapacity industries mentioned by Li Keqiang during the NPC meeting last March. The problem is that this is only 5% of SOE assets.

Table 1: A summary of the guideline on central SASAC reform

Group	Key Instruction	Sector (if applicable)
Strategic	State owned or holding	Important telecommunication, water conservancy and hydropower facilities Grain, cotton, oil, natural gas and other areas of national strategic reserve
	State owned or absolute holding	Strategic mineral resources, oil and gas pipelines, power grids, nuclear power, important public technology platform, geological data, defense
Innovation	Promote "Internet +"	
	Create venture fund to facilitate fintech	
	Enterprises of the Central Scientific Research Institute would restructure with leading corporates	
	Encourage the inclusion of private capital	
Consolidation (M&A)	Reduce competition to foster "going-out" policy.	Equipment, construction, electricity, steel, nonferrous metals, shipping, building materials, tourism, aviation
	Upstream and downstream integration for synergy	Coal, power and metallurgy
	Restructuring	Communication, electric power, automobile, new materials, new energy, oil and gas pipelines, marine equipment, air freight
Cleanup	Rigorous control on investment	Steel and coal
	Highly indebted SASACs could continue to invest if the debt-to-asset ratio remains stable	
	SASACs with a loss for 3 years or above should restructure or enforce bankruptcy	

Source: State Council of PRC, Natixis

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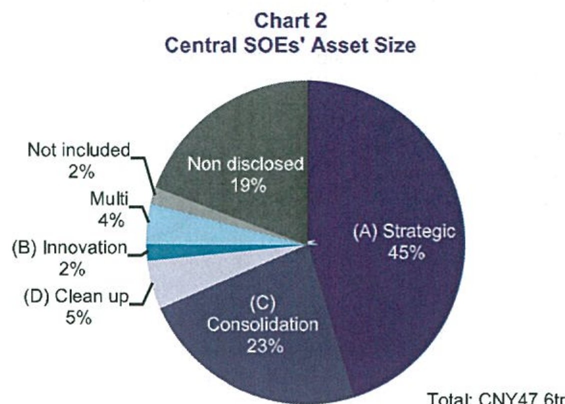
The devil in the details

First, there is no clear initiative to reduce the size of SOEs, as the plan only focuses on restructuring the steel and coal industries while there are many overcapacity/low efficiency ones in China. In fact, the assets of SOEs have only increased in the last few years compared with those of private companies.

Second, the opening up to private capital is only mentioned for the specific case of the innovation group and not generally as hinted in the run up to the NPC meeting in March to finalize the 13th Five Year Plan. It is quite clear that private participation does not imply control. Among all, 45% of central SOEs are considered as strategic by asset size, meaning that the government would retain control even though the private sector could become shareholder in some of the industries (**Chart 2**).

Chart 2
Central SOEs' Asset Size



Source: WIND, State Council of PRC, Natixis

Finally, this relatively minimal restructuring is not even immediate as the target is 2020.

In a nutshell, it seems that the only action in terms of "Darwinian" cleanup, i.e. bankruptcies, would come from the steel and coal industries. But even there, the debt-for-equity swap rumour and consolidation plan run into the opposite direction. In fact, Sinosteel defaulted on an onshore bond of CNY2bn in October 2015 but there is a rumour that a solution will be found for the pending problem, which could take the shape of a debt-for-equity swap (See: A lesson to draw from Sinosteel's restructuring plan). In the same vein, there is plan to create two steelmaking giants by merging all of North and South China steel SOEs, respectively. This shows that consolidation, or any solution that could defer the problem, is still a more favorable approach than a proper cleanup even for the overcapacity industries picked for "cleanup" under the new State Council Guideline.

Table 2: Major M&A by Central SOEs

Date	Name		Industry	Category
May-15	China CNR Corporation	CSR Corporation Limited	Railway	Consolidation
Jul-15	State Nuclear Power Technology Corporation	State Power Investment Corporation	Nuclear	Strategic
Dec-15	Nam Kwong Group	Zhuhai Zhen Rong Company	Multi	Consolidation
Dec-15	China Merchants Group	Sinotrans Shipping Limited	Shipping	Consolidation
May-16	COSCO	China Shipping Group	Shipping	Consolidation
Jul-16	CITS Group Corporation	China National Travel Service (HK) Group	Travel	Consolidation
Jul-16	COFCO	Chinatex Corporation	Food	Strategic
In progress	China Minmetals Corporation	China Metallurgical Group Corporation	Resources	Consolidation
In progress	China National Building Material Company	China National Materials Group Corporation	Building Materials	Consolidation
In progress	Baosteel	Wuhan Iron and Steel	Steel	Cleanup

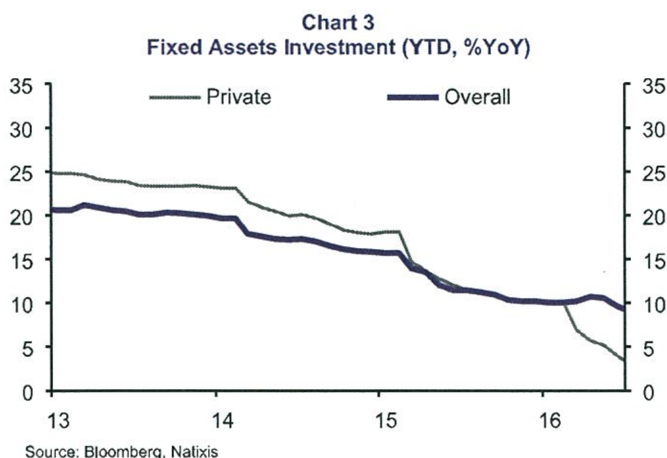
Source: Natixis

Why so little action?

One could feel dismay but such a slow pace for SOE reform and wonder why no action is taken. The answer is simple: there is indeed a tradeoff between reform and short term growth, and the Chinese government has made growth its flagship project. While there would be clear benefits in terms of resources allocation and an increase in the return on assets, the reality is that the cost of funding for SOEs would increase if there is a real restructuring. Not only that, uncertainty would reduce investment and jobs would be shed with negative consequences for private consumption, let along social stability. The impact of reform is too disruptive in the short run and long term benefits are not the key now. The reality is that investment by SOEs is still supporting China's economic growth (**Chart 3**).

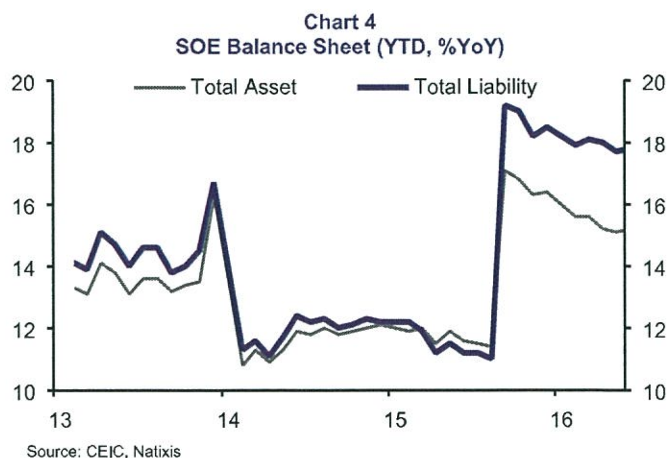
Moreover, the assets held by SOEs have expanded further after August 2015, which makes the problem even bigger. Unfortunately, not only SOE's assets have expanded but also their liabilities, even more rapidly, which means that the problem cannot be deferred forever (**Chart 4**). Evidence of the latter is also that the value added of SOEs is growing much more slowly than that of the private sector (**Chart 5**). This means SOEs are still investing in overcapacity industries, which explains their increasingly low return on assets. In fact, the recent slight improvement is quite correlated with an improvement in commodity prices (**Chart 6**).

Chart 3
Fixed Assets Investment (YTD, %YoY)



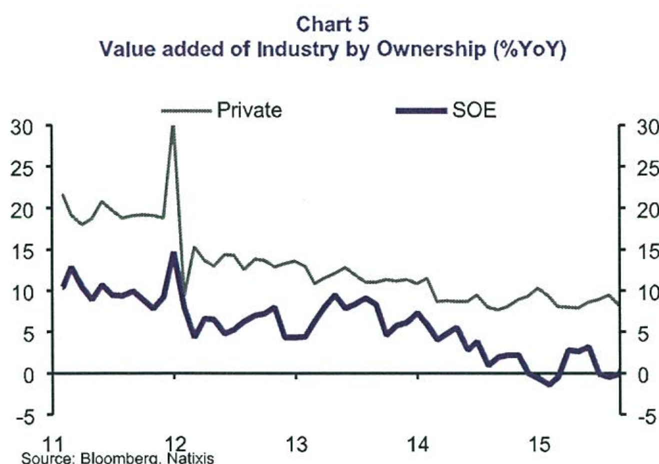
Source: Bloomberg, Natixis

Chart 4
SOE Balance Sheet (YTD, %YoY)



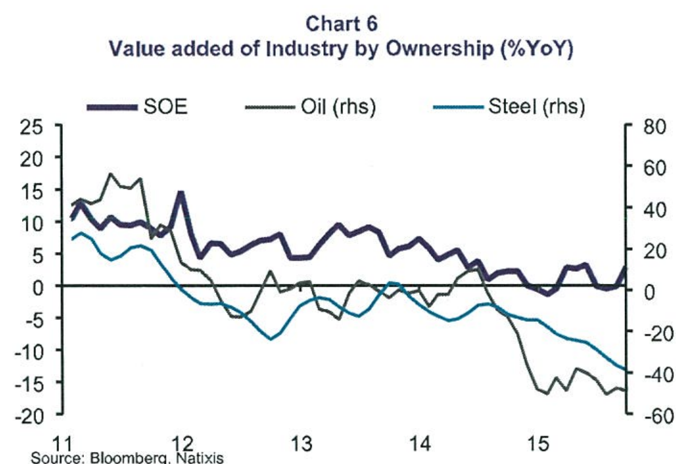
Source: CEIC, Natixis

Chart 5
Value added of Industry by Ownership (%YoY)



Source: Bloomberg, Natixis

Chart 6
Value added of Industry by Ownership (%YoY)



Source: Bloomberg, Natixis

Other than economic growth, the risk of renewed capital outflows is the key concern of Xi's administration. To avoid that, confidence is key so that it is hard to think of major defaults occurring any time soon as they would deter interest by both resident and non-resident investors in the Chinese market. This is why we are of the view that defaults will be avoided at any cost, especially in the offshore market as it continues to act a window shop for Chinese names.

Table 3 shows a list of events associated with SASAC and Dim Sum bond market. The Chinese government has continued to exercise the implicit state guarantee from the case of Sinosteel (the rumour of a debt for equity swap) and Chinacoal. In the Dim Sum bond market, China City Construction International was returned to state-owned status after failure in making repayment.

Table 3: Payment difficulty in SOEs and offhore market

Date	Corporate	Ownership	Industry	Market	Latest Action
Oct-15	Sinosteel	SASAC	Steel	Onshore	Rumor in Debt-for-equity swap
Apr-16	Chinacoal	SASAC	Coal	Onshore	Repay after 7 days
Jun-16	Sichuan Coal Industry Group LLC	Local SOE	Coal	Onshore	Repaid by entursted loan from another SOE
Jul-16	China City Construction Intl	Private (Now state-owned)	Construction	Dim Sum	Returned to the stated owned status and planned to repay half of its outstanding defaulted Dim Sum bonds within the next 60 business days

Source: Natixis

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Key takeaways from a non-Darwinian reform

The thunder is loud, but the rain has been rather light. The announced SOE reform falls short of real action or, at least of relevant Darwinian action to reduce moral hazard and, thereby, improve efficiency and, thereby, the return on assets of SOEs. There are a number of immediate consequences to the lack of "real" reform.

- First, liquidity will continue to be needed, especially for overcapacity industries, which are many more than those addressed in the State Council guidance (steel and coal). **We should, thus, expect lax monetary policy to continue and probably deepen.**

- Second, **the absence of defaults should keep corporate spreads (especially central SASAC ones) low**, even if leverage continues to pile up.

- Third, **the consolidation process, through mergers, will continue** so we should expect increasingly larger-sized SOEs in China. Given that these mergers will be politically driven, efficiency gains will be hard to achieve, if not the contrary as the companies will be much harder to manage. **As SOEs become even larger, the risk of crowding out the private sector only increases.**

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