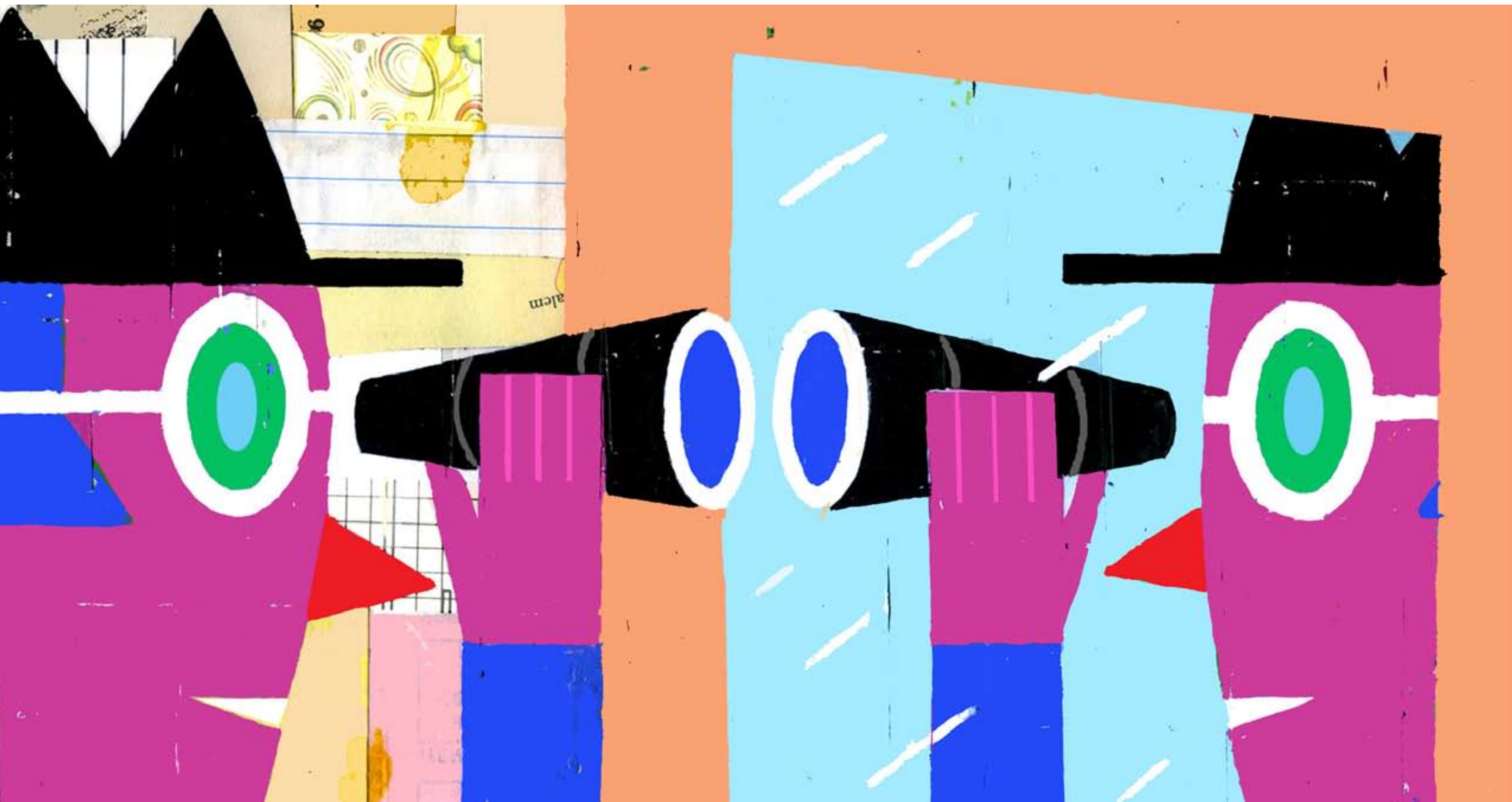
McKinsey on **Finance**



Perspectives on Corporate Finance and Strategy

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Preempting hostile takeovers 1

Companies that stick to valuation basics can capture any value that would make them attractive for takeover bids.

The state of the corporate board, 2007: A McKinsey Global Survey 6

Corporate directors want more information about their companies and industries, and they say that investments by private-equity firms improve governance.

Investing in sustainability: An interview with Al Gore and David Blood 12

The former US vice president and his partner in an investment-management firm argue that sustainability investing is essential to creating long-term shareholder value.

A quiet revolution in China's capital markets 18

Reforms that attracted little attention in the Western world mark a major step forward in the modernization of China's capital markets.

The granularity of growth 25

A fine-grained approach to growth is essential for making the right choices about where to compete.

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A quiet revolution in **China's capital markets**

Reforms that attracted little attention in the Western world mark a major step forward in the modernization of China's capital markets.

James Ahn and David Cogman

When China first began privatizing its state-owned enterprises in the 1990s, the intent resembled that of other privatization programs around the world: to use capital market pressures to improve the performance of a large number of state-owned companies, many of which had weak balance sheets and were not as commercially focused as publicly held companies elsewhere. However, the government wanted to retain substantial shareholdings in and influence over these companies, which precluded the full privatization of state assets. To allow such companies to raise capital in that context, a two-tier ownership structure was put in place. Essentially, the original equity remained legally distinct from the new equity and formed a separate class of shares held by the existing state-linked owners. Although both classes had the same theoretical rights to profits and votes, the nontradable shares could not be sold on the public markets.

As Chinese companies have grown in scale and complexity, this system has faced several challenges. With a two-tier equity structure to manage, state-owned enterprises understandably concentrated on their most important stakeholders: the government and one or two of their largest holders of nontradable shares. Smaller holders of nontradable shares and public-market shareholders had very limited influence either on the governance of these companies or their investment decisions. This arrangement had a negative effect on the development of the Shanghai stock market. After falling from its peak in 2001, when the first wave of IPOs was complete, it progressively declined until mid-2005, losing more than half of its value. Although the two-tier share structure did not cause the slump, the uncertainties it created prevented the market from recovering over the following five years, and it also affected the overall credibility of Chinese stock markets, both as a source of capital and as a vehicle for investment.

Now a second-wave reform effort that does away with the two-tier structure is showing signs that it could spark a revolution in China's capital markets by affecting M&A activity, the equity markets, and corporate governance. Two years ago, the government instituted new policies requiring companies to merge the two classes of shareholdings—in essence, making the nontradable shares liquid. As of this spring, more than 90 percent of state-owned enterprises had already completed plans to that effect; shareholders at the last few companies are expected to finalize their reform plans this year.

This seemingly technical reform received little attention outside China at the time but will have a profound impact on the structure of its capital markets if implementation proceeds as planned. Depending on the specific agreements negotiated between shareholder classes at each company, over the next five years, all shares in China's state-owned enterprises will become fully tradable (Exhibit 1)—thousands of majority and large-minority stakes, spread across the entire economy. In several sectors, they account for up to two-thirds of the equity of all listed companies (Exhibit 2). These reforms will also encourage the development of the country's M&A market by allowing industries to consolidate, improving corporate governance at state-owned enterprises, and expanding the capital markets.

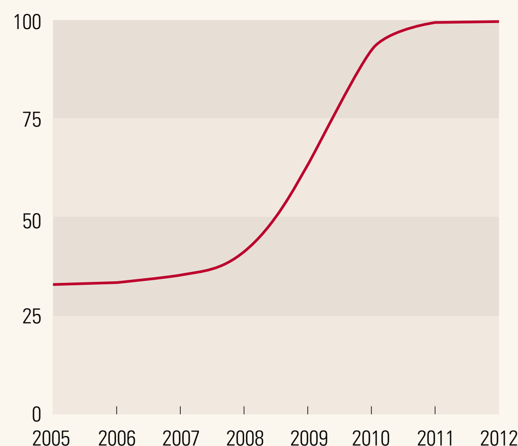
Already, investors who lost significant wealth in previous years have returned to the market en masse, sparking an 18-month rally that has already reversed the decline of the previous five years—and continues at the time of writing. Although the market's performance still attracts considerable attention from investors and the media, as well as the interest and concern of policy

Exhibit 1

A measured transition

Depending on the reform plans approved by shareholders, all formerly nontradable shares will become tradable over the next 5 to 10 years.

Estimated tradable shares as % of total market capitalization[1] in China



[1]Based on stratified sample of ~150 companies' reform plans.

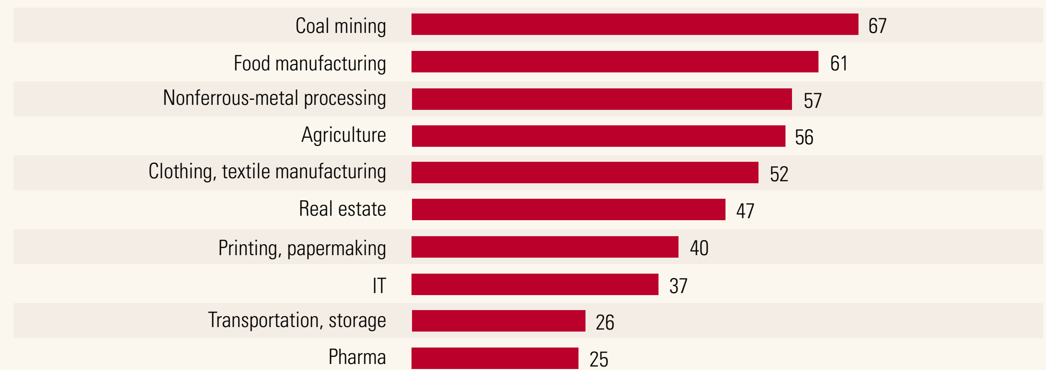
Source: Financial China Information & Technology (FinChina); Shanghai Stock Exchange; Shenzhen Stock Exchange; McKinsey analysis

Exhibit 2

How many are currently untradable?

Today, the proportion of nontradable to tradable shares in total sector capitalization varies across sectors depending on the strategic importance of that sector.

Nontradable shares as % of total sector capitalization, for selected sectors in China



Source: Financial China Information & Technology (FinChina); McKinsey analysis

makers, we believe that the longer-term implications of the latest round of reforms are potentially far more significant.

Setting the stage for reform

As the reforms of the 1990s ran into challenges, the government put forward several different plans for merging the two kinds of shareholdings and making the nontradable shares tradable. None of these early trial runs won the support of the companies and shareholders involved. Public shareholders—in the minority—worried about what would happen to them if the two-tier equity structure were dismantled. Many feared that shareholder value would be massively diluted or that the market would be flooded with more new equity than it could absorb, thus structurally depressing prices.

Owners of nontradable shares had their own concerns. Deals involving nontradable stakes achieved relatively low valuations and faced considerable regulatory difficulty. Transactions involving the nontradable shares required approval from the State-Owned Assets Supervision and Administration Commission of the State Council[1] (SASAC), a government department created to oversee and supervise listed and unlisted state-owned enterprises, and the valuations for such deals were typically quite low—during 2003 and 2004, around a third of the value of the traded shares, on average. Moreover, approval requires an assessment by SASAC that the valuation is "fair"—a determination based on the implied premium or discount to the estimated net asset value in the deal rather than on market-based notions of valuation. Because this approach often created large disparities between the valuations offered by strategic investors and the prices that companies could accept, it prevented deals from going through.

In 2005 China's State Council, the country's chief administrative authority, asked SASAC and the China Securities Regulatory Commission (CSRC), which regulates stock markets, to come up with a definitive scheme to end the two-tier equity structure. The two entities put in place reforms requiring all companies to implement plans to merge shareholdings. Although the companies themselves could determine the specific form and implementation of the

[1] In most cases, the owners of the nontradable shares are some combination of central-, state-, and local-government departments; banks; other state-owned enterprises; and investment companies. SASAC's charge is extremely broad: its ultimate responsibility is to advance the government's overall reform agenda. In doing so, it exercises a governance and control function over state-owned enterprises, appoints directors, approves business plans, and participates in decisions allowing IPOs to proceed.

plans, every plan had to include two key elements. First, no more than 5 percent of the previously nontradable shares could be sold in the first year following the shareholders' approval of an integration plan and no more than 10 percent in the next year. Thereafter, companies could specify longer, voluntary lockup periods, but for most there would be no mandated restriction on the sale of shares in public markets. This measure spreads the impact of the reforms over several years: the first wave of companies to pass a reform plan will see their shares become tradable only in late 2007 and early 2008.

Second, the plans had to involve some compensation paid by the holders of nontradable shares to the owners of tradable ones. A consensus quickly emerged that holders of tradable shares should receive a bonus worth 30 percent of their premerger stake. Most plans approved bonuses to be paid in equity, though many combined it with cash and options. This compensation was a high price for the holders of nontradable shares to pay in order to make their shares tradable. The reforms therefore represented a gamble that eliminating the two-tier structure would attract enough liquidity to make the price worthwhile.

Negotiations over these plans involved instances of shareholder activism that would have been inconceivable in China when state-owned enterprises were first privatized. Under the reforms, each plan had to gain the support of a two-thirds majority of the nontradable shares in a vote and, separately, a two-thirds majority of the tradable shares. Almost all the public debate around share reform centered on compensation for the latter. In several high-profile cases, when companies made offers that were viewed as too low, public figures organized to vote down the plans and forced the companies to make more generous proposals.

M&A market development

These reforms are an important enabler for the development of the domestic M&A market. Many people suppose that the state shareholding SASAC oversees is a single, monolithic block. In fact it is a complex web of different types of shareholders—different layers of government, other state-owned enterprises, banks, and investment companies—often with very different intentions. Around 20 percent of the nontradable equity is in sectors viewed by the government as strategic, where investment is closely controlled. Slightly more than 55 percent is held by strategic investors with a long-term interest in the companies: for instance, those in an upstream or downstream industry or local governments that have invested because the companies are major employers in the local economy. The remaining 25 percent represents shareholdings primarily by state-owned financial investors. Of their holdings, more than 75 percent of the equity (by value) is in sectors open to foreign investment.

As the reform plans go into effect, these financial investors in nontradable shares will for the first time be able to rationalize their noncore investments—a development that could create a wave of M&A activity. That would provide a powerful stimulus for the longer-term development of China's domestic M&A market by forcing companies to develop a sorely lacking experience and confidence in doing deals. The domestic M&A market and cross-border investment in China may well grow too.

The biggest winners will be some of the more aggressive domestic companies looking to consolidate their sectors. What's more, many executives of state-owned enterprises

we've spoken with view the reform as an opportunity to manage their shareholder base more actively by encouraging the departure of passive, nonstrategic investors and bringing in new strategic ones, often foreign companies, that can help them develop their capabilities—for instance, in accessing new markets or technologies. Astute foreign companies seeking to expand their footprint in China will no doubt use the "unfreezing" of ownership structures to find strategic partners of their own.

Uncertainties remain. First, the government also recently instituted a new policy to create a transparent environment for M&A. The policy extensively revises the framework for foreign companies investing in China, specifying which industries are considered strategic and thus not open to 100 percent ownership by private or foreign investors. Many details on the policy's application are unclear, and the definition of "strategic" is so flexible as to accommodate a number of interpretations. Second, SASAC's role will continue to be critical in M&A activity involving state-owned enterprises. Historically, it has acted as custodian of the state-linked portfolio. Although the commission will still be responsible for overseeing state-owned shares, it has signaled interest in concentrating its efforts on the subset of truly strategic companies and progressively opening the rest to market forces. However, it is hard to say how quickly it will proceed down this path.

Capital market expansion

By allowing formerly nontradable shares to be sold, share reform creates a huge pool of equity potentially seeking liquidity—nearly twice the capitalization of the market today and far greater than the new liquidity seen in recent years. The risk of a massive inflow of new shares was a major concern prior to reform. Yet the supply of liquidity into the domestic equity market could grow even more. By the time the last of the nontradable shares becomes fully tradable, in 2012, current plans to reform the pension system and social security, if implemented, will have generated new funds for investment into the equity market. Those funds will be worth two-thirds of the value of all nontradable equity, or around 75 percent excluding sectors with investment restrictions.

This increase will greatly enlarge the base of domestic institutional investors, which today account for only 10 percent of all investors. That huge shift will create a professional-investor segment with holdings that exceed the capitalization of China's domestic equity market today. Indeed, McKinsey research suggests that from 2005 to 2015 the funds under management of China's asset-management industry could grow by as much as 24 percent a year. A professional, organized investor base would also be a powerful force in advancing best-practice governance.

Furthermore, as Chinese middle-class investors gain greater confidence in the equity market, they could generate enormous amounts of new liquidity by shifting their assets to shares from their present low-yielding bank deposits, which now account for almost three-quarters of China's financial assets, compared with around 20 percent in the United States.[2] Because of exchange controls on China's currency, the renminbi, this capital is concentrated within the country. The level of investment activity in recent years in real estate, art, and equities suggests a desire for viable domestic investment opportunities. In that case, domestic stock exchanges would become much more attractive for listing. Already, some high-profile Chinese companies

[2] Diana Farrell and Susan Lund, *Putting China's Capital to Work: The Value of Financial System Reform*, McKinsey Global Institute, May 2006, available free of charge online at www.mckinsey.com/mgi.

that had scheduled IPOs in Hong Kong have changed their plans, deciding instead to pursue a Shanghai listing. Aside from currently favorable pricing, this move has considerable public-relations value.

Over time, a healthy, liquid equity market will also take pressure off the banking system, which today is the principal allocator of capital. A gradual shift from bank debt to equity as the primary source of funding for companies would improve the allocation of capital, make the ability to produce profits more important, and reduce the economy's reliance on the banking system.

The development of domestic equity markets might also make foreign companies with significant operations in China consider the strategic merits of a Shanghai IPO of minority stakes in their Chinese holding companies. Indeed, a few joint ventures have already started to explore this possibility. Although a Shanghai listing would be complex, it has potential strategic benefits: it could mitigate the implicit foreign-exchange risk in funding and send a very strong signal of commitment to China and of success in localizing foreign businesses.

One major uncertainty that remains is how access to the equity markets will be managed. Historically, a government committee approved IPOs, and state-owned enterprises found it far easier to gain approval than did China's emerging private-sector companies. With the recent explosive growth of the Shanghai stock market, companies have become much more interested in new IPOs. Greater access to the capital markets would make private-sector companies less reliant on debt financing, reducing the risks both for them and for the banking system in the event of an economic downturn. It would also allow private enterprise to play a greater role in accelerating the consolidation of many industries.

The reform of China's capital markets still faces significant obstacles. China must further improve the accounting, legal, and regulatory framework needed for equity markets to reach their full potential. Although the government implemented a completely new set of accounting and auditing standards earlier this year, there are simply not enough Chinese-speaking accountants to meet the needs of every listed state-owned enterprise; accounting firms cannot hire and train people fast enough. Similarly, although the legal framework is well designed, enforcement and support—courts, arbitration procedures, experienced lawyers—are still lacking or inconsistent. Finally, effective market regulation typically requires independence and objectivity, but in today's China no government department really enjoys them.

Corporate governance

Currently, China is sailing in uncharted waters as it explores ways to develop its own approach to improving corporate governance.[3] One of SASAC's most heavily publicized initiatives is aimed at encouraging the companies it supervises to upgrade the quality and transparency of their governance. Under the two-tier equity structure, even companies that wanted to implement corporate-governance systems more inclusive of the holders of tradable shares found it extremely difficult to do so. The reforms facilitate a number of important changes. Companies are now allowed to implement share-incentive schemes to align the interests of managers and all groups of shareholders. With the legal distinction between investor classes removed, the importance of the public-market investors will increase and so will the role of the equity markets in allocating

[3] Dominic Barton and Richard He Huang, "Governing China's boards: An interview with John Thornton," *The McKinsey Quarterly*, 2007 Number 1, pp. 98–107.

capital. Companies will feel pressure for greater transparency in their decision-making processes and will focus on generating returns for all equity investors.

It may be too early to say how the development of corporate-governance standards will affect overseas investors, but we are cautiously optimistic. In recent years many industries in China have seen intense competition to build production capacity, partly because mechanisms for allocating capital rewarded companies for top-line growth rather than generating returns on capital. These problems were most noticeable in commodity industries (such as steel, cement, and paper), several of which now have structural overcapacity in China and are destabilizing export markets. A greater role for equity shareholders and better governance will increasingly push management teams to run companies for profitability and not just growth.

Implementing high-quality governance will be a long, challenging process. China will need to address a serious shortage of executives in the mainland with the skill and independence to be competent board members. Because many state-owned enterprises are at an early stage of installing best-practice governance, executives and potential board members will need time to translate their academic understanding of it into practice.

Over the past 25 years, China's market reforms have delivered impressive results in developing product and labor markets. This latest round of privatization lays the foundation for similarly dramatic changes in the country's capital markets and the market for corporate control. MoF

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