Mergers and Acquisitions in China

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In the mid-1980s, China's government experimented with arranging mergers among state-owned enterprises in an attempt to enhance the efficiency of these enterprises. As market-oriented economic reform entered the 1990s, a wave of voluntary mergers and acquisitions involving the state-owned enterprises, collective enterprises, and private enterprises as well as foreign investors has swept the country.

This article provides a detailed description of the Chinese mergers and acquisitions market and seeks to serve two purposes: The first is to provide a starting point for understanding mergers and acquisitions activity in China as it figures into international investment markets. The other is to provide a rudimentary analysis of the advantages and disadvantages of China's approach to mergers and acquisitions, that is, its efforts to transform state-owned enterprises in a centralized planning economy into profit-pursuing firms in a market economy. Given that research in the Chinese mergers and acquisitions market is virtually nonexistent, it would be essentially impossible at this point to present a complete economic analysis regarding the latter issue. The article instead is devoted mostly to the first point—that is, documenting what is taking place in China's mergers and acquisitions market and providing some discussion from the perspective of financial economists.

Turning briefly to evaluating the merits of China's approach seems important, however. While the Chinese mergers and acquisitions market has evolved out of several driving forces and serves multiple purposes, economists have taken a special interest in its role in privatizing or revitalizing state-owned enterprises. Researchers are looking to developments in China as particularly important for a couple of broad reasons. One is that

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the direct political motivation behind the emergence and development of the Chinese mergers and acquisitions market is the need to solve the problems of state-owned enterprises. The other is that the problem of how to revitalize these enterprises inherited from a centralized planning economy is one shared by the countries of Eastern Europe and the former Soviet Union. In light of the importance of this issue, it may be helpful to compare the Chinese mergers and acquisitions approach (along with some other measures) with Russia's privatization voucher program for revitalizing state-owned enterprises. Following that discussion is a description of the mergers and acquisitions market and a discussion of its economic significance in general.

Becoming a Market Economy

For a centralized planning economy to transform itself into a market economy, one of the most difficult tasks is to convert state-owned enterprises into market-oriented, profit-pursuing firms that can contribute to output and productivity growth. While the number of new private enterprises in China is growing fast, that growth is not offsetting the inefficiency of the state-owned enterprises, which are contributing to rising inflation and eating away investment funds that might otherwise be effectively used. Moreover, many state-owned enterprises face possible bankruptcy, which threatens to put workers out in the streets and create accompanying social problems (discussed more fully below).

Developing mergers and acquisitions is one measure China has adopted to solve this problem, an approach that differs from those of East European countries and the former Soviet Union in many aspects. Consider, for example, Russia's voucher program for revitalizing state-owned enterprises. In November 1992 the Russian government decided to privatize its state-owned enterprises by distributing vouchers to its citizens, who would use the vouchers to bid, directly or through investment funds, for a share of the state-owned enterprises when they were put up for auction. The voucher program offered several promising characteristics: (1) It was implemented swiftly, and that swiftness was thought to be a virtue by its promoters following the idea of Poland's "big bang" (Jeffery D. Sachs 1992).[1] In about one year, 7,000 Russian state-owned enterprises were privatized through the voucher auction (Lynn D. Nelson and Irina Y. Kuzes 1994). (2) The program by design aimed at equity, with every citizen given an equal number of vouchers. (3) The program's single purpose was to achieve privatization of state-owned enterprises, with efficiency enhancement expected to follow as a natural result, at least in the long run. However, the voucher program has failed both to revitalize the state-owned enterprises and to achieve and maintain equity, according to some economists (Nelson and Kuzes 1994). Because the voucher auctions have injected neither capital nor better management skills and technologies into the state-owned enterprises, privatization has not improved productivity as expected. The program's failure to maintain equity among the people is, despite all its good intentions, one of its most significant shortcomings (Nelson and Kuzes 1994). Enterprise insiders and voucher speculators have eaten away the lion's share of the state-owned enterprises while common people are left at a great disadvantage. Such a result should perhaps not be surprising in a country lacking established institutions—visible and invisible—essential for a successful market environment.

Unlike the Russian government, which apparently chose the voucher program as a means of achieving radical political goals by demolishing the old economic system swiftly (see Nelson and Kuzes 1994), the Chinese government seems to have more pragmatic considerations. China seeks to combine economic growth with the transformation of state-owned enterprises and has adopted a policy of reforming them gradually, one by one. The idea behind the mergers and acquisitions approach, as well as other measures, is to let the state-owned enterprises be voluntarily acquired by or merged with other, better state enterprises, collective enterprises, private enterprises, and foreign business interests. Such an approach has combined ownership transfer with management adjustments, technology upgrading, and capital injections. While the one-by-one approach may privatize ownership more slowly, it may help avoid the painful shock of finding the economic environment and reformed enterprises abruptly mismatched. The government has more time to rectify problems that arise during the process and to establish a compatible market environment. The disadvantage of this approach may be that the solution will not keep pace with the fast deterioration of the state-owned enterprises. It is too early yet to evaluate the virtues and vices of China's approach. Given the unsatisfactory results of other, speedier approaches in Russia and some other Eastern European countries—for example, Poland—it will be interesting

to see whether China's gradualism will succeed in reforming the state-owned enterprises.

The discussion that follows focuses primarily on China's mergers and acquisitions market itself—how it has come into existence, what its characteristics are, and how it may develop in the future. The privatization issue will be considered again as appropriate.

A General Background of China's Economy

Economic Reform: 1978-95. The mergers and acquisitions market in China has emerged as a logical outgrowth of the country's economic reform, which began in 1978 in the agriculture sector. The centralized planning economy was on the verge of collapse, and the key idea behind reformation was to replace the existing commune system with the family farming network. The result was dramatically improved agricultural output. In 1984 the government began reforming industrial enterprises as well, with a goal of converting them into profit-seeking units. Unfortunately, high inflation following the political upheaval in 1989 stalled the reform. In early 1992 when Deng Xiao Ping launched a campaign to revitalize the economic reform program, it picked up again and began to extend to other parts of the economy such as the financial sector and the tax system.

China's economic reform has obtained some positive results. In the last seventeen years, China has kept a near double-digit real (inflation-adjusted) growth rate. Per capita gross domestic product (GDP) for 1994 was only $431, but actual purchasing power was much higher because of low price levels (The State Administration of Statistics of the People's Republic of China [SAS] 1995b). Foreign direct investments increased at an average annual rate of 40.7 percent between 1983 and 1993 (Knight-Ridder 1994); at the end of 1994, 206,000 joint ventures and foreign subsidiaries had investments of $291.43 billion (SAS 1995b). Total exports had reached $120 billion by the end of 1994, total imports were $115 billion, and the foreign currency reserve reached $51.6 billion (SAS 1995b), which was ranked one of the largest in the world. In December 1990, Shanghai Securities Exchange (SHSE) was established, and in April 1991, Shenzhen Stock Exchange (SZSE) followed suit, both growing rapidly in the last couple of years.

Given the Chinese economy's rapid growth and its enormous potential, the emergence and development of its mergers and acquisitions market are likely to be significant in the international economic community. As will be discussed, one difference the market will make is in opening up an additional channel for foreign investors to participate in the Chinese economy.

Table 1
Industrial Output by Enterprise Type
(Percent)

Type of Enterprise	1978	1994
State-owned	77.6	34.1
Collective	22.4	40.9
Private and foreign	0.0	25.0

Source: SAS (1995a).

A Taxonomy of Enterprise Ownership. As the essence of mergers and acquisitions is restructuring the ownership of enterprises, a taxonomy of the current ownership of industrial enterprises in China might be informative as background for the discussion. It is important to remember, of course, that the ownership structure of these enterprises has been changing constantly and any simple classification such as the one presented here can serve only as a reference point for further understanding.

Ownership of enterprises in China may be sorted into three categories: state ownership, collective ownership, and a combination of private and foreign ownership. The state-owned enterprises vary in size, and their production scope covers heavy industry, light industry, and the service sector. They contributed 34.1 percent of China's total industrial output in 1994, a much lower share than that of sixteen years earlier (SAS 1995a; see Table 1). The collective enterprises are usually small and are concentrated in light industry, agriculture-support industry, and the service sector. Their total capacity, however, has expanded rapidly since 1978, and these enterprises contributed 40.9 percent of the total industrial output in 1994. The private enterprises are mostly in the service sector, and foreign enterprises cover a broad spectrum of manufacturing. They together contributed 25 percent of the total industrial output in 1994; most of these enterprises did not exist in 1978. A subcategory of the private industrial enterprises is 8 million so-called sole proprietors (see Table 2), which are not merger or acquisition targets given that their average number of employees is small.

State-owned Enterprises. A state-owned enterprise is one established by the government, owned nominally by "all the people of China," and managed by government-appointed bureaucrats. Before 1980, no state-owned enterprise pursued profits but instead served as a government agency carrying out directives from its superiors. These directives specified the goods to be produced or distributed and the compensation to be received by workers. The raw materials and bank credits needed for the operation were allocated to the enterprise directly or indirectly by the State Planning Commission and the Ministry of Finance. The administrative superior of a state-owned enterprise was one or a few of the following bodies: the ministry in charge of the industry in which the enterprise was categorized, the provincial government, or the city government. The managers' goal was solely to fulfill the government plan, without having to consider business decisions, such as input and output prices, which were fixed by the government.

Table 2
Number of Industrial Enterprises by Ownership
(Thousands)

Ownership	1978	1994
State-owned	n.a.	102.2
Collective	n.a.	1,863.0
Township/village	15,240.0	24,945.0
Private and mixed-ownership (excluding sole proprietors)	0	44.5
Sole proprietors (rural and urban)	150.0	8,007.4

Source: SAS (1995a).

Entering the 1980s, the government began experimenting with reform measures aimed at enhancing the efficiency of state-owned enterprises (Jinlian Wu 1987). The reform advanced along two lines, one being to devolve decision rights to the enterprise managers and the other, to reform the price system, the tax system, and the financing system so that the economic environment would be more like a market and state-owned enterprises would respond to market signals. The results have been mixed, and many problems remain unsolved: unsuccessful alignment of incentives for labor, management, and the government; lack of management experience and skills needed in a new environment undergoing market-oriented transitions; aggressive competition from collective enterprises and foreign enterprises; and high operation costs owing to material wastes, shirking, redundant workers, and backbreaking welfare burdens.[2]

Collective Enterprises. A collective enterprise is nominally owned by its "guardian" or "sponsor," usually another company, a social organization, or a government agency, but it is usually quite independently operated by its management team. More often than not, the initial capital of a collective enterprise is contributed by the guardian or borrowed from the state banks or other institutions using the guardian's influence and connections. In the first case, the guardian may be entitled to a portion of the enterprise's profits; and in the latter, the guardian is usually entitled to an annual fee from the enterprise. The management team, which acts like a de facto owner, cannot claim the residual profits but has discretion about how to reinvest the profits and whether to disburse them as bonuses within the explicit or implicit limits set by the company charter and government regulations. Production by a collective enterprise is not planned by the government. Its managers decide what goods to produce or what services to provide, but they do so, of course, within the parameters of having to obtain raw materials and credits in the marketplace. Prior to 1978, a collective enterprise often found itself ignored by the economic planning system. During the 1980s, they benefited from economic reforms and, with their competitive advantage of management flexibility, low labor costs, and autonomy regarding the retained after-tax profits, they began to thrive in the more marketlike environment. Their success may partly explain why more and more collective enterprises have been set up under the encouragement of rural townships and urban municipalities since economic reform started. (See Table 2, which lists township enterprises, a subcategory of collective enterprises, separately.)

Private and Foreign-owned Enterprises. For ideological reasons, private enterprises were all but nonexistent before 1978. They were allowed to come into existence then under the explosive pressure of mass unemployment manifested in the homecoming flood of city youths, who had been coaxed and coerced to the countryside during the cultural revolution (1966-76). The first such enterprises were usually small businesses in the service sector, most of them operated by an individual or a family. While a small portion of them have subsequently grown into bigger opera-

tions and forayed into manufacturing, most have remained small in both scale and scope. The number of firms that are wholly or partly owned by foreigners, in the form of joint ventures or independent companies, has mushroomed throughout the nation since 1978, thanks to the open-door policy to attract foreign capital. The role of both private and foreign-owned enterprises is expected to grow quickly.

Joint-Stock Companies. In the late 1980s, the Chinese government began implementing ownership reform for state-owned and collective enterprises. The ultimate goal is to limit the government's role in a state-owned enterprise to that of a shareholder with limited liabilities. For collective enterprises, reform involves redefining or clarifying the ownership shares of the involved parties, after which the enterprise is called a joint-stock company. A joint-stock company may have several classes of shares: those held by individual investors, those held by institutions, and those held by the government. The individual shares, which are listed on the stock exchanges, include A-shares, which are traded among domestic investors, and B-shares, which are traded among foreign investors; the institutional shares, called C-shares, are traded on the Stock Trading and Quotation System (STAQ) or the National Electronic Trading System (NETS). The state shares may be purchased only through negotiation with the government. In 1994, the number of state-owned enterprises converted into joint-stock companies increased to 25,800 from 13,000 in 1993 and 9,440 in 1992 (Jinshen Zhang 1995). Over the same period, about 3 million collective enterprises converted to joint-stock companies (Zhang 1995). Current policy makes it likely that most state-owned enterprises and collective enterprises will follow suit.

The conversion of enterprises into joint-stock companies is significant in the development of the mergers and acquisitions market in a couple of important ways. One is that it lays a rudimentary foundation for ownership transfer through public offerings and merger and acquisition activities because after the conversion it is easier to transfer ownership from one party to another. Well before the stock market came into existence in China, some joint-stock companies began to exploit the operational advantage of restructuring their ownership by selling stocks to their own employees as well as other institutions. Another significance is more profound: without unlimited financial backing from the government, a joint-stock company converted from a state-owned enterprise is expected to compete in the market like a collective or private enterprise. A natural consequence is that some state-owned enterprises may come out alive and well while others will end up facing bankruptcy, a result that expedites the development of the mergers and acquisitions market because the last hope for some of these enterprises may lie in being acquired or merged.

*D*riving Forces behind Mergers and Acquisitions

Mergers and acquisitions are an integral part of any market economy, enhancing an economy's efficiency by reallocating and recombining production resources for better use. As China pushes its market-oriented economic reform into the 1990s, there seem to be three reasons behind the emergence of its mergers and acquisitions market, reasons that are likely to continue driving the market's development.

The government is essentially being forced to restructure and revitalize the state-owned enterprises, especially the unprofitable ones (for example, see Anding Li 1995). The plan involves three steps: severing the government from these enterprises by redefining the government's role as a shareholder with limited liabilities; revitalizing large and some medium-sized state-owned enterprises by further devolving decision rights to management and continuing economic reform toward a fair and competitive market; and selling and renting the small and some medium-sized state-owned enterprises to competent public or private entities. This policy has basically opened the door for mergers and acquisitions of small and medium-sized state-owned enterprises. For large state-owned enterprises, the possibility of letting some be partially or wholly privatized remains a sensitive issue but is being considered by the government.

A second force behind the growth of the mergers and acquisitions market is that it is called for by the growing needs of the enterprises themselves as they seek to implement their development strategies (Jixiang Ni and Zhigang Zhu 1994). Profitable enterprises, either collective or state-owned, may need to expand their capacities, upgrade their technologies, diversify or streamline their products, invest in a new industry or divest from an existing business, enter into a new geographic area, and the like; the mergers and acquisitions market provides them an efficient channel for achieving these goals. The many unprofitable enterprises also stand to benefit, potentially breathing in

new life through being acquired by or merged with other enterprises. In other words, industrial growth in the last fifteen years has brought the Chinese economy to a point of readiness for an active mergers and acquisitions market that will facilitate its internal structural adjustments.

The third dynamic encouraging development of China's mergers and acquisitions market is that it helps enterprises attract more international capital (Ni and Zhu 1994). Foreign investments in China usually take one of three forms—establishing and operating a joint venture with a local partner, investing in listed stocks, or acquiring or merging with an existing enterprise. Joint ventures are the most common form of foreign investment since 1978; because they involve the detailed operation of a project, the foreign investor usually needs to possess expertise in the particular business. Investing in the stocks of Chinese firms is a purely financial market activity, and the opportunities are available to the general public; the investment targets are limited, however, to the companies listed in the domestic and foreign stock exchanges.

In comparison with these means of investment, investing in a Chinese firm through merger or acquisition offers several advantages: (1) The investor may choose to attend to the acquired firm's daily business, but he or she may not necessarily have to do so. Such a form of investment may, therefore, be suitable for industrial companies as well as general investors through holding companies. (2) Potential investment targets are much more numerous than those listed on the stock exchanges. (3) Cash flow may be generated in a shorter time than in the case of a joint venture since a plant does not have to be built from scratch. (4) The investor may have full control of the acquired company, which is not attainable in a joint venture because the law stipulates that the management of a joint venture must be equally shared by local and foreign investors irrespective of their capital shares. (5) Most importantly, a merger or acquisition deal may be attractive to an investor because it offers land use at little or no cost, ready-made distribution channels, skilled labor, technical and commercial information, and so forth—even when a target has been a money-losing enterprise.

Driven by these forces, many voluntary merger and acquisition activities sprouted in China in the late 1980s and early 1990s, with the active support of local governments. The long-anticipated official sanction of the central government was issued on November 14, 1993, when it passed the landmark document *A Resolution on Several Issues in Establishing a Socialist Market Economic System*, which formally acknowledged the value and legitimacy of private enterprises and endorsed more liberal reform measures for state and collective enterprises.

An Overview of China's Mergers and Acquisitions Market

Historical Developments. Of the factors contributing to the economic motivation for opening up the mergers and acquisitions market, the severe problems of the state-owned enterprises have done the most to tilt the political balance toward government acceptance of mergers and acquisitions. The inefficiency of the state-owned enterprises is a long-standing problem, and in the context of the market-oriented reform the survival of many of these has become an imminent issue as they hinder further economic development and reform. Nearly half of them are incurring losses, and many if left to their own resources would have already gone bankrupt. In recent years, the government has allocated 60 percent to 70 percent of annual fixed-assets investments from banks—all are state banks—to state-owned enterprises, largely to bail out those suffering losses (see Mark Spiegel 1994, for example). Such nonproductive fiscal expenditures account for the major portion of the fiscal deficit and contribute to the country's recurrent high inflation, which in 1994 was 24.1 percent for the nation and much higher for some major cities (SAS 1995b).

Early government attempts in the mid-1980s to reform the state-owned enterprises included measures to arrange mergers and acquisitions. The result, however, was less than satisfactory if not in fact a failure (Deqiao Hu 1994). Among the arranged mergers only a few generated some synergy, which usually dissipated very quickly, and many turned out to be disastrous because of conflicts of interests that materialized. Little efficiency enhancement should have been expected, though, given that the mergers and acquisitions essentially involved management adjustments and production replanning without consideration of ownership issues, capital injection, or technology upgrading and given that, being arranged by the government, the activities lacked the motivation for success of profit-seeking enterprises.

Since the late 1980s, the government has been experimenting with other reforms for state-owned enterprises—for example, letting incurable firms go

bankrupt and transferring the ownership of some other firms to the public through free-market-style mergers and acquisitions. The bankruptcy experiment has progressed slowly because there is no social safety net for absorbing released workers, and private job growth is not fast enough to absorb the workers either. The mergers and acquisitions market has gained vitality, though, in the 1990s. State-owned enterprises may merge among themselves, and enterprises and private enterprises are also allowed to join the game on equal footing. In contrast to the mergers and acquisitions of the mid-1980s, the activities in this round are voluntary, and they may cross kinds of ownership, industries, and regions. In 1993 alone, more than 2,900 enterprises, most of them small and medium-sized, were merged or sold in the sixteen major cities of China, including Tianjin, Shanghai, Guangzhou, Wuhan, and Shenzhen; 6 billion yuan ($1 = 8.3 yuan) of assets changed hands, and 400,000 employees were reassigned (Xinhua News Agency 1994). In addition, the role of the securities market in mergers and acquisitions has been exploited. In October 1992, the first acquisition of a public company through the secondary securities market was accomplished, and several other companies have followed the example.[3]

Foreign investors are participating in the current mergers and acquisitions market and are at least half-heartedly welcomed. Their participation injects more capital into China, which is good news, especially to the local governments. On the other hand, the central government is concerned about the loss, or the possible loss, of control over certain industries to foreign investors. The official policy has swung back and forth, reflecting the government's ambivalence. Foreign investors in this arena must maneuver without a complete set of guiding laws, and the lack of such a framework may work for or against their activities. For example, because the policy area is gray, some mergers and acquisitions transactions by foreign companies are structured as joint ventures while others are plain vanilla mergers and acquisitions.

The Chinese government finds the results of merger and acquisition activities largely encouraging (Hu 1994). As expected, these activities have revitalized some state-owned enterprises and relieved some of the government's financial burden. One result has been more efficient allocation of production resources as assets have been enlivened by transfer from the low efficiency state-owned enterprises to the new owners. International investors are also reacting positively, clearly attracted by the additional investment channel China offers (see Hu 1994, for example).

Privatization. Privatization of many state-owned enterprises is likely to be the most long-lasting type of merger and acquisition activity. For example, Vantone Company, one of the largest private enterprises that has prospered from the booming real estate business in Hainan Island, has made inroads into retail and pharmaceutical businesses by acquiring state-owned enterprises. The company started with initial capital of 60,000 yuan in 1990 and by 1993 had become a profitable conglomerate with assets of 3.5 billion yuan (Vantone Company 1993). Another well-publicized example is the Wuhan Dadi Science and Technology Company, a private enterprise that acquired the medium-sized state-owned Wuhan Matches Plant at the end of 1993 at a price of about 70 million yuan (Liang Chang 1994).

Along with privatization has come significant growth in the number of entrepreneurs as the mergers and acquisitions market has provided opportunities for people to start and expand their own businesses. In recent years, many small firms have been bought out by independent entrepreneurs or the firms' employees (Hu 1994).

Merger and Acquisition Targets. The Chinese government has several criteria for deciding which enterprises can be allowed to enter the mergers and acquisitions market: First, the merger or acquisition should be carried out gradually so that the economy will not be subject to a shock. Second, control of the crucial outputs important to national security and economic health should be maintained. Third, the mergers and acquisitions market should move forward on an experimental basis (preferably embracing first those enterprises facing the most difficulties) as the government keeps some flexibility in adjusting its policy. In this spirit, the government has stipulated that (1) the mergers and acquisitions of state-owned enterprises should be compatible with the government's industrial strategy; (2) state-owned enterprises related to national security, military defense, advanced proprietary technologies, scarce mineral mining, and other specified areas cannot be sold to private or foreign investors; (3) a state-owned enterprise in a pillar industry such as energy, transportation, or communications may be partially sold, but a majority share must be retained by the government; and (4) any merger or acquisition deal of a large state-owned enterprise that is the backbone of an industry must be reviewed individually (Bureau of State Assets Management 1995).

Most state-owned enterprises that are put on the market for sale or merger by the government are small or medium-sized, have a long history of operating losses or a lack of promising products, and are subject to a high level of debts. Selecting enterprises with these characteristics is consistent with the central government's motivation to revitalize the money-losing state-owned enterprises and to test and start the mergers and acquisitions market with small and medium-sized enterprises.

When a large or profitable state-owned enterprise needs outside capital, the central government seems to prefer to let it go public rather than to sell it. The securities market, however, is still in its developmental stage and each year stingy quotas, explicit or implicit, are issued to the local governments for initial public offerings. To list in the securities markets in foreign countries (such as on the New York Stock Exchange or the Hong Kong Stock Exchange), a Chinese company has to get approval directly from the central government, and getting such approval is next to impossible for most state-owned enterprises. This situation has forced some large or profitable state companies, which need capital injections and technology upgrading, to venture into the mergers and acquisitions market and sell themselves. They are able to do so because of the consent or support of the local governments, which are eager to attract capital to the local economy. Some cities have thus stepped ahead of the rubric policies of the central government and become pioneers in the so-called ownership revolution.

China seeks to combine economic growth with the transformation of state-owned enterprises and has adopted a policy of reforming them gradually, one by one.

As mentioned above, the government also puts many collective enterprises, profitable or unprofitable, on the market for sale. They are usually small or medium-sized, and the government has fewer restrictions on their merger and acquisition deals. Private enterprises have had such a brief development history that they do not figure as merger and acquisition targets; their ownership transfer, if any, usually occurs within a circle of friends and relatives. Private-to-private merger and acquisition deals are uncommon not because of government discouragement but because these enterprises are not developed fully enough to be attractive merger or acquisition targets.

As discussed above, many merger and acquisition deals for state-owned and collective enterprises are executed after they have been converted into joint-stock companies. A mergers and acquisitions transaction for a joint-stock company target is technically easier because of the company's clearer ownership definition.

The Institutional Environment. Committed to making its transitions gradually, the government has been conservative in institutionalizing procedures for addressing issues in the mergers and acquisitions market. Because existing economic institutions are not designed for a free market operation, rules must be drafted as the game is being played, with the frequent result that they may be both vague and redundant. Existing institutions are intended to address the specific issues of the legality of deals, valuation of assets, and facilitation of transaction. The complicated and often confusing nature of government control over merger and acquisition activity has evolved somewhat out of rational consideration of the issues but also simply out of the bureaucratic machine.

Which regulatory agencies are involved in a merger and acquisition case depends on the ownership of the target and the type of acquirer, among other things. When the target is a state-owned enterprise, at least five government branches will be consulted: the Economic Planning Commission, the Administration for State Assets, the Administration for Industry and Commerce, the department in charge of the industry of which the target company is part, and the Commission for Restructuring Economic Systems. If the acquirer is a foreign investor, the Ministry for Foreign Trade and Economic Cooperation will also be included. For a publicly traded company, the Securities Regulatory Commission of China has a role.

The size and importance of the target company usually determines which level of the government is involved. A deal involving a small state-owned enterprise probably controlled by the local government can usually be approved locally. A medium-sized state-owned enterprise is likely to be jointly supervised by both the local and the central government, and the negotiations have to be carried out on both fronts. Most large state-owned enterprises are under

the direct control of the central government, and any merger or acquisition deal involving these companies would be carefully reviewed by the central government.

The question of who represents a state-owned enterprise being targeted for merger or acquisition is often a point of contention between local governments and the central government as well as between the government and the company's management. The central government recently tried to reassert its control in the matter by stipulating that (1) the management of a state-owned enterprise has no right to sell the company without authorization; (2) only the designated agent, in most cases the Administration for State Assets, can represent a state-owned enterprise in a merger and acquisition deal if the enterprise has not already been converted into a joint-stock company; (3) a joint-stock company is the property of its shareholders, who have decision weights according to their shares, and the rights of the state shares are to be exercised by the Administration for State Assets; and (4) the acquirer of a state-owned enterprise may be an individual or an institution (Ni and Zhu 1994).

When the merger and acquisition target is a collective enterprise, the matter is simpler. As discussed earlier, a collective company, whose ownership is often vague, is usually controlled by the company's management while another company, a government agency, or a social institution acts as its guardian. Because collective enterprises tend to have a looser relationship with the government and their production focus is mostly on consumer products, the government has less interest in their merger and acquisition deals. In most cases, a deal is negotiated exclusively between the acquirer and the management of the target company, with final approval obtained from the guardian and a formal application filed with the government.

To acquire a joint-stock company, all an investor needs to do is to amass a controlling stake through stock purchase in the secondary market or negotiation with the shareholders, a practice similar to that in most western countries. Acquiring a public company through the secondary market requires careful observation of securities laws and regulations: Foreign investors are not allowed to buy A-shares or take more than 5 percent of the ownership by holding B-shares. They may, in principle, purchase C-shares and state shares by dealing directly with the holders.

There are 174 property exchanges, established by the local governments and major financial institutions in recent years, that serve to facilitate merger and acquisition transactions and enforce government regulations. Specifically, the exchanges collect and disclose information about merger and acquisition prospects, assist both sides in procedures, and provide other consulting services. They also furnish information and experience to the government in formulating merger and acquisition policies on issues such as asset evaluation, debt settlement, and employee placement. Fourteen of the exchanges operate at the provincial level, 104 at the city level, and 56 at the lower municipal levels (Ni and Zhu 1994).[4] While a few exchanges are active and developing quickly, the rest are not ready to function properly. In all likelihood, many of the city and lower municipal exchanges will be consolidated to the provincial level and networked nationwide.

Because the mergers and acquisitions market is in an experimental stage, most related regulations are in the form of provisional rules, which will be revised into permanent laws over time. Continual changes in the regulations should therefore be expected, and they will be open for interpretation as they are evolving. Such a legal environment offers investors both opportunities and risks: while investors may find more freedom in structuring and negotiating deals, they may also lack solid legal protection. China is speeding up the process of establishing a legal system in line with international standards. Each year sees progress in the passing of laws and in the clarifying of legal issues. However, full establishment of properly functioning legal institutions is a long-term goal.

*F*oreign Investors

For the Chinese government foreign capital and management skills are vitally important in the mergers and acquisitions market if the country is to achieve its presumed economic goals. For international investors the mergers and acquisitions market in China offers another channel for participating in this growing economy and reaping financial rewards.

Investment Channels. Foreign investors have three channels for carrying out equity investments in China: one is to buy listed stocks of Chinese companies, another is to set up a joint venture with a local company,[5] and the third is to acquire part or all of a Chinese company. The three channels span a spectrum of investment characteristics, with stock markets and joint ventures at either end and acquisitions in between.

Stock Markets. Two stock exchanges have been established in China since late 1990, one in Shanghai and the other in Shenzhen. By the end of 1994, 289 stocks were listed, some of which were accessible to foreign investors (Shanghai Securities Exchange 1995 and Shenzhen Stock Exchange 1995). Besides that, approximately twenty Chinese stocks are listed on the Hong Kong Stock Exchange, New York Stock Exchange, and other markets. Even though the domestic exchanges are experiencing rapid growth and a few more stock exchanges are likely to be established, it seems certain that the listed companies will remain a small fraction of the 100,000 state companies and millions of collective enterprises. Such an investment channel therefore will remain of narrow scope even if the access barrier for foreigners is completely dismantled. Some investors may also hesitate to choose this channel because of the excess price volatility and the irregularities typical of infant stock markets (Economist Intelligence Unit 1995a) as well as the fact that the stock markets are subject to the government's intervention. Investing in stocks does offer the advantage of liquidity, though, which streamlines an investment process down to portfolio management (buying and selling) and thereby relieves the investors of involvement in the operational details of the underlying companies. Because it does not require fine-tuning the management of a company, such an investment channel is accessible to a wide variety of investors who may not possess technical expertise in the underlying business.

Joint Ventures. On the other end of the spectrum as investment opportunities for foreigners are joint ventures, which have been the most common form of direct investments in China since economic reform began in 1978. A new joint venture enjoys preferential tax treatment: no tax for the first two years and half tax for the next three. There are drawbacks, though, because capital invested in a joint venture may have a low level of liquidity and cash flow may not be realized for a long time because of plant construction. A joint venture involves detailed management, and investors using this approach are usually companies already in the same business.

Acquisition. Acquisition of part or all of an existing company is an investment approach that in some respects falls between the above two. Compared with setting up a joint venture, acquisition takes a shorter time to start production and see cash flow. It is also easier for the investors to sell the acquired firm after repackaging it. To protect against this risk, many joint ventures are restricted from ownership transfer by contract. Investors may choose to get involved in the technical and managerial details of an acquired company, as they would do in investing in a joint venture. Or they may choose not to get involved, as in stocks. Either way, an investor's degree of control of management is predicated by the share of ownership. Since the daily operation may not be necessarily attended to if so chosen, such an investment opportunity may be accessible to a bigger pool of investors, who are not necessarily experts in that particular trade, through holding companies.

Investing through acquisition also offers the advantage of less government intervention than forming a joint venture or purchasing listed stocks. Acquisition is a means around several restrictions. In some industries, for example, there is a cap on ownership share of foreign investors in a joint venture. Furthermore, management in any joint venture has to be equally shared between the foreign and local shareholders, irrespective of their ownership shares. In the stock markets, a foreign investor cannot own more than 5 percent of a company's stock. In comparison, a foreign investor may acquire either part or all of a target company, and his control of the management is always weighted fairly by his share.

Special Concerns. Foreign investors may have concerns about whether the contract in a merger and acquisition deal (or any other commercial deal) will ultimately be honored and whether business disputes will be fairly arbitrated. For protection, many insert a clause in the contract that allows them to bypass the Chinese courts. Such a clause specifies that disputes would be taken to the China International Economic and Trade Arbitration Commission (CIETAC) for judgments. CIETAC was created in the late 1980s when the Chinese government joined the international agreement 1958 New York Convention on the Enforcement of Foreign Arbitration Awards. By doing so, the government promised to honor any arbitration involving Chinese institutions or companies, made either in China or abroad.

CIETAC has earned a reasonably good reputation, according to a report by Business China (Economist Intelligence Unit 1995b). The commission consists of professional arbitrators, including ninety from other countries, and awards are rendered within forty-five days of the close of arbitration proceedings. According to the same report, about 80 percent of recent cases ended up in a judgment rather than a conciliation, compared with 50 percent some years ago. A CIETAC award is final and binding according to Chinese law and is not subject to revision of any courts. CIETAC

has become popular among foreign investors and is the busiest arbitration center in the world, handling more cases than the well-known, much-used Stockholm Chamber of Commerce. One uncertainty has been whether the local courts would, in the environment of regional protectionism common in China, effectively enforce the commission's arbitration award if problems resulted. So far most judgments and conciliation have been honored without the need for enforcement; when enforcement has been needed, problems have been minimal.

The Future of China's Mergers and Acquisitions Market

As outlined earlier, China's strategy in developing its mergers and acquisitions market is driven by the government's desire to reform low-efficiency state-owned enterprises, adjust the industrial structure, and attract foreign investments. Those goals are likely to remain strong ones, guiding the country's economic development, and the mergers and acquisitions market is likely to move forward, albeit along a bumpy path. Several issues will be relevant to its development.

Economic Issues. Currently, the mergers and acquisitions market is a buyers' market and subject to imbalance. For example, in the Enterprise Ownership Exchange Fair sponsored by Hunan province in 1993, only 4 out of 161 enterprises were sold on the spot (Ni and Zhu 1994). One factor contributing to this situation may be that it will take some time for the idea of mergers and acquisitions to become fully appreciated and exploited by the industrial circle in China, as was true for the stock markets. It is important to remember that China was a central planning economy only sixteen years ago. A second important factor is that the mergers and acquisitions market is still in the experimental stage according to the government's strategic plan, as discussed earlier, and a lot of policy uncertainties will not be fully resolved until the government has gained more confidence from the experiments. It also makes a difference that the business norm, including intermediation agencies and operational protocol, has not been established yet. As a result, deals often fall through because of miscommunication or unreasonable expectations. A fourth factor shaping the current imbalance in the market is that information is not properly dispersed, and neither domestic nor international investors are fully aware and confident of the opportunities. As these problems are resolved over time, the demand-supply imbalance may change.

China has applied to reenter the World Trade Organization, and if the application is accepted development of the mergers and acquisitions market is likely to accelerate. China will have less domestic market protection, and its businesses will face more international competition. One consequence is likely to be an increase in bankruptcy for money-losing enterprises, some of which may become acquisition targets. Even currently profitable enterprises may benefit from being merged to reposition themselves for the more intense competition.

For the Chinese government foreign capital and management skills are vitally important in the mergers and acquisitions market if the country is to achieve its economic goal.

The potential benefits to China from foreign investments are enormous, and it would be a rational choice for the government to maintain a policy of welcome for international investors. Given the country's population of 1.2 billion, the consumer market along with the investment market is practically impossible to saturate if the economy stays on a reasonably healthy and stable path. The government has planned that in the next ten years China will invest $500 billion in its infrastructure alone, and a sizable portion of that amount needs to come from international capital markets. The energy industry, for example, will need to raise $20 billion in foreign capital before 2000 (Knight-Ridder 1995). The mergers and acquisitions market provides a valuable channel for attracting foreign capital, and against this general backdrop it is likely to become more open to international investors, with adjustments in policy details occurring from time to time.

Institutional Issues. For a healthy mergers and acquisitions market to develop, the institutional environment needs to resolve policy uncertainties, provide information services, and establish a compatible

financing system. The first of these areas concerns, in particular, China's policy toward ownership reform—specifically, how fast state and collective enterprises are allowed to be converted to joint-stock companies. As discussed, a joint-stock company may be easier to deal with in a transaction than a state or collective enterprise. At another level, the policy to encourage or discourage such conversions is closely related to the government's attitude toward privatization, which significantly dictates the depth of the mergers and acquisitions market. Privatization is still a politically sensitive word at this point, but the government is liberal enough to list ownership reform as a priority in its economic agenda, and the "Corporate Law" passed in 1994 has provided a legal ground for such reforms.[6] While more state and collective enterprises are expected to be converted and some to be privatized, privatization does not seem to be keeping pace with ownership reform.

Asset-Evaluation Agencies. The asset-evaluation agencies are set up by the government to address potential underpricing of state assets in mergers and acquisitions transactions. Given that the spirit of free markets is to let buyer and seller determine a fair price through free negotiations, one may question the necessity of such evaluation agencies. A partial reply is that in China a state-owned enterprise often suffers severe "agency problems," which is to say that the interest of the state may not be always properly represented by the designated managers or the local government officials. In fact, it is not uncommon for either managers or local governments to underprice state assets in order to advance personal or local gains. On the other hand, as part of the government the asset-evaluation agencies may have the problem of conflict of interest when a state-owned enterprise is involved in a merger and acquisition deal. It has been suggested that the evaluation agencies should be severed from the government to enhance their independence.

Securities Market. The development of China's securities market may have a positive impact on mergers and acquisitions activities in that it provides a better investment atmosphere. In particular, it may provide information and liquidity for acquiring a listed company, and it is also a possible exit for cashing out of an acquisition. In the last three or four years, the institutional framework has been established for the primary and secondary stock markets, which are expanding with amazing speed. But it is not known if or when foreign investors will be allowed to acquire more than 5 percent of a company through the stock market.

Financial System. China's banking system, under tight control of the government, still operates on the Soviet model, which provides little service and support to the mergers and acquisitions transactions unless so directed by the government as in some rare cases in the past. In recent years, gradual reform has begun to separate the functions of the central bank, the policy banks (banks that carry out the government's industrial policy instead of pursuing profits), and the commercial banks. Banks have a long way to go, however, before they become competitive and efficient and able to provide financing for mergers and acquisitions activities.

Related to financing of mergers and acquisitions activities is the issue of credit rating, which is an unfamiliar concept to most Chinese people. Without a system to evaluate the creditworthiness of business entities as well as individuals, a crucial link in the chain of finance is missing. Bad debts among state-owned enterprises have caused periodic systemic crises in recent years. A few cases of credit disputes involving Chinese companies in international activities have also been reported. Such an environment is not only hazardous to the development of the mergers and acquisitions market but also inhibits foreign investment and stunts the growth of the domestic financial markets in general. Establishing independent credit rating agencies will be only the first step in solving the problem. More importantly, cultivating a civilization pillared by the idea of individual responsibilities will be a long-term project—and no easy job in a country where people were deprived of individual decisions for thirty years before they were unfettered but also lost in the collapse of communist ideology.

Political and Social Issues. Several political and social issues will influence the development of the mergers and acquisitions market. The first is unemployment. Some background will shed light on the seriousness of this problem. According to government statistics, the total population in China is 1.2 billion, with 14 million babies born each year (see Ding Li 1995 and SAS 1995a). There are 768 million people currently aged between 15 and 59. The labor force is about 600 million (see Table 3), and more than 10 million people enter the job market each year. Among the 168 million in the urban work force, 2.7 percent are unemployed and 10 percent are on welfare while nominally employed by a state-owned enterprise. Among the 446 million in the rural labor force, 13 to 25 percent are estimated to be oversupplied and 50 million-100 million of them are migrating among the cities looking for a job. By 2000, there will be 500 million

in the rural labor force while only 200 million will be needed in agriculture and 100 million in the township enterprises. The remaining 200 million will look for jobs to the cities, which at the current pace of development will be able to absorb only 20 million of them by then (Ding Li 1995). With such dire long-term prospects for the labor market, the immediate unemployment pressure is no comfort at all. Half the state-owned enterprises, even though (under the direction of the government) they are eating away 60 to 70 percent of the fixed-assets investments from banks, are still losing money. This unsustainable fiscal policy not only fuels the rising inflation but also strands the government in a difficult dilemma: if it keeps subsidizing the low-efficiency state-owned enterprises, desperately needed fast economic growth and job creation will remain seriously hindered; if it lets the state-owned enterprises go on their own, many of them will face bankruptcy and the result will be immediate massive unemployment.

The mergers and acquisitions activities are a double-edged sword to cut through the unemployment problem. On one side, an acquisition may save many jobs by revitalizing a potentially bankrupt enterprise and may help the economy create more jobs and lessen inflation pressures by relieving the government of a financial burden. On the other hand, an acquisition often results in immediate downsizing of the bloated work force, which transforms a latent economic inefficiency into a conspicuous social problem. The government is therefore likely to maintain a cautious policy toward any work-force cuts following an acquisition or a merger at the same time that it is encouraging the development of the mergers and acquisitions market. In other words, the government may prefer to have big/strong fish eat small/weak fish without spitting out the bad parts; and contracts in a mergers and acquisitions deal may often preclude shutting down factories and laying off workers (Joyce Barnathan 1995). Some other measures promulgated by the government, such as the establishment of a social safety network, may also help. According to the Labor Ministry, about 95 million, or two-thirds, of urban workers now have unemployment insurance, up 20 percent from 1993. Under the plan, a worker who loses a job receives 70 to 80 percent of his or her salary for two years as unemployment compensation, then 20 to 50 percent thereafter as welfare, or the worker can choose a lump sum compensation with which to start a small business (Knight-Ridder 1995).

A second issue is the political resistance by several groups against mergers and acquisitions (Jia Lu 1995). One such group consists of the old guard, who believe that the privatization of state-owned enterprises and the development of private enterprises are ideologically unacceptable. Without convincing alternative proposals, however, they are losing their audience. Another group is made up of economists and sociologists disturbed by the fact that some mergers and acquisitions deals have generated egregiously unequal wealth distribution. Their argument is best appreciated in those cases in which people have exploited legal loopholes to get rich quick. Workers who have lost their jobs and others whose interest has been hurt may very well join forces with this opposition group, and the matter could be further complicated by concerns about strategic national interests in some cases involving foreign investors. Given these realities, people who support the idea of mergers and acquisitions have cautioned against possible slips if the market develops too fast without an adequate legal environment in place. However, they believe that as long as tactical prudence is exercised in the process, the opposition will not be strong enough to stunt the market's development.

Table 3
Employment of Civil Work Force, 1994
(Thousands)

Rural	446,541
Township/village enterprises	120,182
Urban	168,160
State-owned enterprises*	112,140
Collective enterprises*	32,850
Private and mixed-ownership enterprises (excluding sole proprietors)	10,920
Sole proprietors	12,250

* Includes employment in nonprofit organizations such as government agencies, hospitals, and schools.

Source: SAS (1995a).

The third issue is the possible loss of state assets (Ni and Zhu 1994). In mergers and acquisitions activities, many state assets are transferred, at a price, to private ownership. Given the market's immaturity and the deficiency of the regulatory and legal systems, the government has a concern that some transactions

may be or may appear to be carried out to the state's disadvantage and result in a loss of its assets. One complaint is that intangible assets, such as business and technology know-how, trade secrets, and brand name recognition, tend to be undervalued the most. Although the potential problem of state asset losses may not be enough to justify wiping out the mergers and acquisitions market, it is important that the transfer of state assets to private owners be accomplished in an orderly manner and at a fair price. Establishment of business protocol and the maturing of the market may help to eliminate the loss or the appearance of loss of state assets.

It has been observed that local governments tend to weigh the potential problem of state asset losses less than the added value brought by mergers and acquisitions activities (Qing Xiao 1994), a position that adds to the contention between the central and local governments. The 1994 tax law stipulating that state-owned enterprises belong to and must submit their profits to the central government has prompted local governments to sell state-owned enterprises whose current control is in the gray area. The bank law passed in 1994 has rightly reduced local-government say on the control of bank credit allocation, and the problems of many local state-owned enterprises are likely to be aggravated. The local governments may in turn have an incentive to adopt more lenient policies toward mergers and acquisitions.

Whether China's general economic development, which is the backdrop for the mergers and acquisitions market, can follow a steady path is also an important question. One major risk lies in the lack of an efficient system of social institutions—the lack of an effective judicial system to enforce contracts, a tax collection system fully compatible with the market economy, a sustainable social welfare system, an independent central bank and a market-oriented banking system, a credit-rating system, and the like. Progress in these areas has been made but not as quickly as one might have hoped. Among other reasons, rampant corruption throughout the society, resulting from the lack of efficient checks and balances of power as the country is undergoing dramatic social change, may serve as an indicator for how quickly the system can be in place.

Conclusion

This article has provided an introduction to the mergers and acquisitions market in China, placing the emergence of that market in the context of China's market-oriented economic reform. It attempts to analyze the direct and indirect driving forces behind mergers and acquisitions activities and reviews relevant historical developments and current challenges to development of a strong mergers and acquisitions market.

The development of mergers and acquisitions activity in China has played a positive role in revitalizing its inefficient state enterprises, attracting foreign investment, and rationalizing the industrial structure. The merger and acquisition activity has inevitably led to the privatization of some state and collective enterprises, which is still a sensitive ideological issue. While further development of the mergers and acquisitions market is important in restructuring and modernizing the industry of China, careful handling of many institutional deficiencies and social problems as well as political obstacles will be required to avoid major setbacks in the future. It is hoped that this article's broad overview of the development of China's mergers and acquisitions market will invite further study of this important dynamic in China's economic system.

Notes

1. The "big bang" of Poland refers to the period of rapid economic structural changes implemented by the government around 1992, including the privatization of state enterprises en masse (through voucher distributions).
2. Workers in a state enterprise are entitled to permanent employment, free housing, free medical care, and other fringe benefits. Running a state enterprise could be like running a small welfare state.
3. Baoan Group, a public company listed on the Shenzhen Stock Exchange, acquired Yanzhong Company, listed on the Shanghai Securities Exchange, in October 1992. The acquisition stirred a great deal of attention and debate at the time.
4. China is administratively divided into about thirty provinces, each covering two types of municipalities—cities and counties. Unlike in the United States, in China a county is a small city.
5. A less common form of this approach is for a foreign company to set up a subsidiary in the country that is 100 percent owned by itself.
6. The Corporate Law is legislation regarding registration, governance, and other matters related to business entities.

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