Chinese Soe'S Equity Diversification Based on Nanjing Gaoke

Yongqi Li[1, a]

[1]Jiangxi University of Finance and Economics, Nanchang, China.

[a]yucky_li_jxufe@163.com

Abstract

This paper is mainly aim to analyze whether China's soe is able to transform into a market-oriented asset holding company. It begins to explain how Chinese SOEs have become the dominant players in the Chinese economy and emergency capital markets. After that, evaluating whether China could establish competitive state-owned asset investment holding companies for domestic as well as international markets.

Keywords

Chinese soe; Nanjing Gaoke; Shareholding Company.

PART ONE

1. How Chinese SOEs have become the dominant players in the Chinese economy and emergency capital markets.

1.1. Traditional State-Owned Companies

In a planning economy, the market did not function at all and SOEs had no economic autonomy in deciding what to produce and how to produce. Most importantly, there were no incentive mechanisms in the traditional SOEs to reward workers for improvement of production and management efficiency. As such, extremely low production and management efficiency were the typical characteristics of traditional SOEs.

1.2. The Reform of Traditional SOEs

1.2.1. Goal of the Reform

The ultimate goal of the reform was to provide production autonomy and incentive mechanism to SOEs for them to decide on the supply of products according to market demand.

1.2.2. Features of State-Owned Companies after the Reform

(1) The market-oriented production became more dominant

The reform started by letting SOEs produce extra products outside of the planned production and sell these extra products in the market for profit. Gradually the market-oriented production became more dominant than planned production.

(2) Rely on sales and borrowings to support expenditures instead of government fiscal budget

From 1980, the reform of li gai shui (conversion of profit into taxes) had since required SOEs to submit corporate tax in lieu of production revenue to the authorities. Hence, SOEs could no longer receive the regular planned funding from the government fiscal budget but had to generate operational and financial funding from market-oriented businesses and commercial borrowings, such as bank loans.

(3) Reformed SOEs were still directly linked to the government

Their assets were owned by the state; as long as the state-owned assets were not privatised, whatever profits or new assets the SOEs did acquire were still state-owned in nature. So long as state ownership remained, SOE management came under the control of government

ISSN: 2637-6067 DOI: 10.6918/IJOSSER.202004_3(4).0031

authorities responsible for their promotion and remuneration. In short, they were more like government officials rather than managers and employees in a corporate typical of a market economy.

(4) Gain easy access to loans from state-owned banks

With such government linkage, SOEs could nonetheless gain easy access to loans from state-owned banks simply because the various governments that owned SOEs in name were effectively guarantors for the bank loans. In fact, many local governments usually exercised their administrative power to direct the state- owned banks to lend to SOEs for government-promoted projects and, sometimes, for funding needs required by loss-making SOEs.

1.2.3. Vital Issues Facing the Reformed SOEs

How would the market-oriented operations be effectively implemented by the government-controlled management in reformed SOEs? How could the government-backed commercial lending not be used by SOEs to increase financial leverage aggressively or even to cover their losses?

1.3. How Goke Has Become The Dominant Players In The Chinese Economy

Throughout the company's 25 years of development, Nanjing Gaoke had altered its corporate management structure, business portfolio and investment structure. These changes were driven in part by its own initiatives to achieve more flexibility and efficiency in business operations, and catalyzed by new opportunities and competitors as well as the booming Chinese market economy.

1.3.1. Build Shareholding Company

Gaoke from other LGFPs was that instead of selling the land use rights, the Nanjing municipal government used the rights as the share contribution to Nanjing Gaoke for the controlling shares. Although the Nanjing municipal government could not gain fiscal revenue by selling the land use rights, it gained two advantages from the shareholding company.

Firstly, the initial cash investment required for the ETDZ development could be raised from other shareholders. As such cash equity capital could be used as a liquidity asset to meet the expenses occurred in the first development stage of the ETDZ and Nanjing Gaoke could avoid heavy borrowing from the banks, hence maintaining a healthy financial leverage structure.

Secondly, the structure of the shareholding company paved the way for Nanjing Gaoke to become a listed company able to raise financial resources from the emerging stock market.

1.3.2. Find An Alternative Financing Channel

The intention of this reform was to provide incentive for the original and controlling shareholder to improve the financial performance and thus be able to benefit from the enhanced share price from participating in secondary market trading.

Thanks to the enthusiasm of China's investors for the new stocks in the 1990s, Nanjing Gaoke managed to issue 50 million of new shares at RMB7.84 per share. The earnings per share was RMB0.0845 at the time of IPO. The price earnings ratio of the IPO share was 89.65 times. Nanjing Gaoke successfully raised RMB380 million from the IPO issuance. The new public investors paid 7.84 times of the premium for RMB1of the original equity capital. With the addition of public investor shares, Nanjing New Port Development General Corporation's equity shares were diluted to 49.66%, which was still an absolute controlling shareholding.

1.3.3. Establish A Competitive State-Owned Asset Investment Holding Company

Details are in part two.

ISSN: 2637-6067 DOI: 10.6918/IJOSSER.202004_3(4).0031

1.4. How to Be Dominant in Market of Soes Through Reform of Mixed Ownership

1.4.1. Cooperate with Different Strategic Investors

The partner is "no borders" and strives to solve the problem of insufficient qualified strategic investors. With the increasing degree of market openness, increasingly fierce competition and the increasingly decisive role of the market in resource allocation, the integration of public and non-public, domestic and overseas, industrial and financial capital has become a scale-up of enterprises. Indispensable ways to diversify investment, avoid risks and improve efficiency.

1.4.2. Hire Senior Management Without Frame

Selecting and hiring senior management "no frame" to ensure that the mixed reform project has a good "leader". In line with market requirements, mixed ownership enterprises promote the professional manager system, break the original rules and regulations, rank seniors, and insist on meritocracy.

1.4.3. Unlimited Salary Incentives

Salary incentives are "no limits" and gradually implement market-oriented benchmarking. In terms of salary incentives, in the case that the total wages can be included, Group A implements "double benchmarking" for mixed-ownership enterprises: operating performance and benchmarking of advanced enterprises, and compensation levels are also benchmarked against advanced enterprises. "Do not eat big pots of rice" and not pay balance, effectively stimulating the vitality of mixed ownership enterprises.

1.4.4. Strict Audit Supervision

Audit supervision "no dead ends" to prevent the loss of state-owned assets. Set up a supervisory management institution of the company, and send supervisory committees to the lower-level enterprises to attend important meetings and conduct effective supervision in "before" and "in-the-fact"; the group audit and risk control institutions are sound, and they can realize the various enterprises including mixed ownership enterprises. The full coverage of the enterprise audits; the discipline inspection and supervision departments at all levels of the group effectively carried out the work, and also achieved full coverage of discipline inspection and supervision for all enterprises; the party committee inspection work of the group also covered mixed ownership enterprises.

PART TWO

2. Evaluate whether China could establish competitive state-owned asset investment holding companies for domestic as well as international markets.

2.1. Problems Facing to State-Owned Asset Investment Holding Companies

2.1.1. Multi-tier System Was the Highly Independent Investment Business Partnership

The core of the multi-tier investment management system was the highly independent investment business partnership. Since these investment partnerships platforms were operated according to profit- sharing contract between Nanjing Gaoke and private partners, substantial investment profits would have to be given to private individuals. The investment profits gained by the private individual partners could reach abnormally high levels. It could sharply contrast with the rather fixed and low remuneration received by Nanjing Gaoke's management and staff who were still government-appointed but worked in these business partnerships and made their contributions. If such abnormal income divergence persisted, it could lead to a conflict of interest among members working in these partnerships. For example,

ISSN: 2637-6067 DOI: 10.6918/IJOSSER.202004_3(4).0031

the general manager of Nanjing Gaoke was the government-appointed official who could not link his personal economic benefit to the company's business performance at all.

2.1.2. Restricted by the Nanjing Municipal Government'S Local Objective

The business development through the multi-tier investment system could penetrate well beyond the Nanjing area where the Nanjing municipal government could hardly exercise its administrative power. The business development strategy of Nanjing Gaoke could then be affected or restricted by the Nanjing municipal government's local objective.

2.1.3. Faced Dynamic and Intense Competition in the Open Capital Market

The multi-tier investment management system faced dynamic and intense competition in the open capital market. It was thus ultimately so contradictory to the government administrative system that basically followed rigid bureaucratic rules.

2.2. Steps Gaoke Did To Establish Competitive State-Owned Asset Investment Holding Companies

2.2.1. Move into the Financial Industry to Gain A Kind of 'Risk-Free' Profit.

Along with the aggressive penetration into the high-tech manufacturing sector, Nanjing Gaoke had made an equally aggressive move into the financial industry. The investment in financial institutions was the most rewarding investment for Nanjing Gaoke's diversified portfolio expansion if based on the contribution of this investment in financial institutions to the atypical growth of Nanjing Gaoke's assets. One of the most rewarding investments in financial institutions was the investment in Nanjing Bank. Thanks to its status as the Nanjing municipal government's directly controlled SOE, Nanjing Gaoke could have priority in investing in the newly merged Nanjing Bank as one of the major initial shareholders. Since commercial banks had long dominated China's financial system as the sole fundraising institution, commercial banks could easily lend the raised fund for a stable as well as a fat interest spread income through the controlled interest rate system. Hence, the investment in Nanjing Bank ensured Nanjing Gaoke a kind of 'risk-free' profit.

2.2.2. Asset Liquidity Feature to Lower Investment Risks

Nanjing Gaoke was transforming from holding long-term committed and illiquid assets to a flexible investment portfolio. This asset liquidity feature was arguably the most important advantage of its portfolio as many Chinese companies, particularly LGFPs, relied on high-cost short-term borrowing in the shadow banking system to support their long-term committed investments, resulting in very risky mismatched maturity structure of asset and liability. It was well-known that such maturity mismatch could easily trigger off liquidity risk if the long-term committed invested assets failed to deliver the promised performance and the troubled company might have to use a Ponzi scheme to maintain its debt burden by continuously rolling over the short-term borrowings.

2.2.3. Investment Through Platform to Transform It Into A Professional Fund

Nanjing Gaoke increasingly committed investment into projects through the platform of its initiated and managed PE funds, a clear strategic decision from management. The platform would not only extend its funding resources by more flexibly attracting external equity resources but could transform Nanjing Gaoke from a corporation operating a few specific companies into a professional fund controlling diversified and securitised assets from many companies. Ultimately Nanjing Gaoke could transform into a diversified national and even international fund management company, such as Singapore's Temasek Holdings, with an extensive portfolio.

ISSN: 2637-6067 DOI: 10.6918/IJOSSER.202004_3(4).0031

2.2.4. Diversified Portfolio to Manage A Healthy Financial Leverage with Stable Income

Through portfolio diversification, Nanjing Gaoke fundamentally changed from a LGFP performing the function of financing the ETDZ to a state-owned asset investment holding company controlling investment assets in various industries from urban infrastructure, construction, property development, logistics, electricity and electronics, pharmaceuticals, and telecommunications to natural resources and finance.

Based on its considerably diversified portfolio and asset structure, Nanjing Gaoke could generate stable business revenue and net income and manage a relatively healthy financial leverage compared to many Chinese SOEs, corporations and shareholding companies.

2.2.5. Multi-Tier Investment System to Decentralize Investment Into Different Tiers

Nanjing Gaoke began a series of reforms in its investment system aimed at building a multi-tier system for more efficient decision and management based on investment size. The investment autonomy for specific projects in new business areas was decentralised to various VC funds structured in the form of limited business partnerships and key managers in these partnerships were external private partners. They were no longer Nanjing Gaoke's employees and were hence not directly subject to the control from Nanjing Municipal State-owned Asset Supervision and Management Commission. They took responsibility for making the investment decisions and shared profits from the invested projects.

With such a multi-tier investment system in place, Nanjing Gaoke's corporate management system had distanced itself so much more away from the government administrative controls and the investment decisions had been decentralised into different tiers.

2.2.6. A New Strategy Paying Attention to Potential Sectors Without Regional Restrictions

In 2015, Nanjing Gaoke announced a new strategy to push its business portfolio expansion to be more focused on "Grand Healthcare and Grand Venture Capital Investment". Since the businesses of real estate development and urban infrastructure had been basically restricted to the Nanjing areas and hence had relatively limited expansion potentials, this new strategy for "Grand Healthcare Sector and Grand Venture Capital Investment" was eventually aimed at transforming Nanjing Gaoke's business portfolio to be more focused on the businesses of pharmaceuticals and healthcare and equity investment as they were not subject to regional restrictions and have great business potentials.

In conclusion, we can see from Gaoke China are capable to establish competitive state-owned asset investment holding companies for domestic as well as international markets.

3. Work Cited

[1] NANJING GAOKE: COULD CHINA'S SOE BE EFFECTIVELY TRANSFORMED INTO A MARKET-ORIENTED ASSET HOLDING COMPANY?, The Asian business case centre, CaoYong, 2017.

[2] Discussion on Financing of State-owned Enterprises, Cooperative Economy and Science and Technology, Cong Xin, 2019, P70-71.

[3] Analysis on the Implementation Path of Mixed Ownership Reform of Local State-owned Enterprises, Operation Management, Liao Yingcan, 2019, P43-44.

[4] Problems and Improvement of Corporate Governance of State-owned Enterprises, Economic Forum, Li Pulin, P47-50.