# Chapter Four

# China's Emerging Market for M&A

## Introduction

The market for corporate control is taken as an external mechanism to motivate management to perform efficiently. The market for corporate control is the place where firms are sold and bought, or are taken over. In China this market has played a special role in the transition process. The initial creation of the market for corporate control started with initiatives from the Chinese government with the purpose to reduce the number of money-losing SOEs. After the reforms started in 1979, a large number of SOEs lost money in the fierce competition: in 1995 about 45% of the SOEs, which had 20 million employees, were in the red. Since bankruptcy was not a policy option during the initial phase of China's economic reform, the government promoted these failing SOEs to merge with profit-making enterprises. The policy seemed to have been effective: from 1995 to 2002 the number of SOEs decreased by 46%, while the total amount of profit in RMB increased by 163,6% (State-owned Assets Supervision and Administration Commission of the State Council (SASAC), 2004).

There was no private enterprise involved in the market for corporate control before 1992. All transfers of property were organised within the state sector. After 1992, socialist ideology in China allowed the privatisation of SOEs. Slowly private ownership became considered to be an "important component of the economy" (The 15th CCP Congress, 1997). On the other hand, the accumulated personal wealth after more than ten years of reform enabled some individuals to own an enterprise. A number of small private companies developed successfully in niche markets. Moreover, the policy "grasping large state firms and releasing small ones," which means privatising small-sized SOEs while retaining large ones under the supervision of the government, fostered the market for corporate control to become an important instrument to change ownership from SOEs to private enterprises. In particular, the Chinese stock market provided an arena for M&A players. According to the statistics from SASAC (June 6th 2004), from 1995 to 2002, the number of medium and small-sized SOEs decreased by about 39,2%.

Because of the positive effects, M&A continued to play a key role in government's development strategy. In 2002, the "*Suggestions on Economic and Social Development 15th Five-Year Plan*" passed at the fifth plenum of the Communist Party's 15th Congress, backed "the suitable use of international investment, and positive experimentation with M&A, investment funds and securities investments and other methods of using long-term foreign investment". The Chinese government has firmly backed this stance.

This chapter firstly reviews the historical development of China's market for corporate control. The M&A activities in China's stock market will be discussed in Section 4.2. Then China's institutional environment of M&A is subject of Section 4.3 followed by the analysis of the driving forces behind M&A in China in Section 4.4.

## 4.1 Historical Development of China's Mergers and Acquisitions Market

The first merger in China took place in Baoding, a small city in North China. In 1984, the municipal government promoted four money-losing SOEs to merge with four other profit-making SOEs in the city. The experiment was so successful that many other cities followed this model. More than 1.500 SOEs at the end of 1988 were merged over the country and 2.559 cases were reported in 1989 (Zhang, B. et al., 1995).

M&A in this period was government-led and oriented towards non-commercial objectives. The state aimed to escape the burden of supporting loss-making enterprises by merging them with "stronger" firms. Some profitable enterprises were forced to merge with or purchase a loss-making enterprise. The result of such M&A was mixed. B. Zhang et al. (1995) reported that in Baoding, the merging companies' post-merger profit increased by 223% compared with pre-merger profit. However, Dong and Hu (1995) argued there was little synergy generated from the activities and some of them turned out to be a disaster because of the lack of the motivation of the profit-seeking enterprises. Dong and Hu (1995) argued that little efficiency enhancement could be expected without consideration of ownership issues, capital injection and technology upgrading. Although the results might be mixed, M&A were an accepted phenomenon in China.

Since the late 1980s, the government has induced bankruptcy and "free-market-style" M&A in the reform of SOEs. The central government's 1994 decision (Document No.59) to authorise 18 cities (subsequently expanded to more than 100) to experiment with "optimisation of capital structures" stimulated a sharp acceleration of mergers and bankruptcies.

During the 1980s, most mergers involved enterprises in the same trade, locality, and ownership system. After 1990, mergers linking firms from different industries, regions, and ownership systems are no longer an exception. For example, the television producer Konka is one of many firms that now operate plants in several provinces. Conglomerates like Capital Steel span diverse industries. In 1995, the central government issued the new policy "grasping large state firms and releasing small ones", which opened up to the privatisation of small-sized SOEs while still keeping large ones under the control of the government. This policy decision speeded up the M&A in China.

In contrast to the M&A in early stages, the later activities were more initiated by the firms themselves replacing personal and political ones. Enterprises used acquisitions purely for business reasons: to acquire land-use rights, expand the scale of production, rationalize product lines, penetrate new markets, or ensure access to key inputs. For example, the 1997 merger of four powerful petrochemicals firms in the Shanghai-Jiangsu region (two provinces in the east of China) was commercially motivated by tie-ups among strong firms (Wang, S., 1998, p. 152).

But the Chinese government is still in control and applies several criteria to decide which SOEs are allowed to enter the market of M&A. Firstly, the merger or acquisition should be carried out gradually so that the economy will not be subject to a shock. Secondly, control of the crucial outputs important to national security and economy should be maintained. Thirdly, the mergers and acquisitions market should move forward on an experimental basis (preferably embracing first those enterprises facing the most difficulties) so the government can adjust policies when needed.

At the same time, the M&A market has gained vitality for not only SOEs but also private enterprises and foreign enterprises were allowed to join the game. After 1990, foreign firms entered into China's market for corporate control. By the end of 1996, 10 of China's 59 largest tire manufacturers, 12 of the 13 largest pharmaceutical firms, and 70% of the largest beer producers had come under the control of foreign firms (Research group on M&A and Bankruptcy, 1997).

More recently, firms have begun to use capital markets as vehicles for mobilizing funds to finance corporate acquisitions. The establishment of two stock exchanges certainly facilitated the development of M&A.

In September 1993, the private Shenzhen-based Baoan group initiated China's first corporate raid, launching a surprise share-buying campaign that enabled the firm to become the largest shareholder in the public Shanghai-based Yanzhong Ltd. However, the hostile takeover[11] has not been the dominant procedure in the market for corporate control (see the next section). Konka, the television producer, has repeatedly used share issues to finance corporate takeovers. Although firms require

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[11] Hostile takeover is a tender offer that proceeds even after it has been opposed by the management of the target.

official approval to gain access to domestic or international markets for shares or corporate bonds, some firms have succeeded in gaining indirect capital market access through the device of purchasing “shell” corporations, which means an unlisted firm becomes a public firm by buying a listed company in the stock market.

The creation of asset management companies (AMC) associated with the four big banks adds a new dimension to enterprise re-organisation. In the CPE thousands of SOEs relied on financial support of the government via the “policy lending” from four state-owned banks. In the late 1980s and through the 1990s, more “policy lending” was aimed at propping up uncompetitive SOEs as part of China’s gradualist approach to transforming the economy from a centrally planned to a "socialist market” economy. The credit even extended to finance enterprises’ losses, workers’ wages and pension fund obligations. It is not surprising that large numbers of SOEs defaulted on loans from state-owned banks, which led to tremendous non-performed loans (NPLs). The Chinese government recognised that the situation jeopardised the health of the financial system and could not continue indefinitely. Therefore China’s State Council in 1999 approved the establishment of the four Bank Asset Management Companies (AMCs): Huarong AMC, Cinda AMC, Great Wall AMC and China Orient AMC. The Bank AMCs are wholly state-owned, non-bank financial institutions and remained under the supervision of the Peoples Bank of China. Each of them has a registered capital of RMB10 billion (approximately US$1.2 billion), directly funded by the China's Ministry of Finance (the "MOF"). Four state-owned banks have transferred their NPLs to their respectively linked, but independent AMCs: The Industrial and Commercial Bank of China transferred its NPLs to Huarong AMC; China Construction Bank to Cinda AMC; Agricultural Bank of China to Great Wall AMC and the Bank of China to China Orient AMC. The transferred amount was limited to NPLs that were supplied to SOEs before 1996. Recent statistics published on the Bank AMC websites reveal that the four together purchased NPLs totalling some RMB1.3 trillion. The Bank AMCs began their major activity with swapping the debt for equity. The final aim of the AMCs is to rehabilitate the loss making large SOEs and eventually liquidate their stakes by selling or listing the shares of the firms. The Bank AMCs usually hold equity derived from a debt-equity swap for a "fixed period," during which they are trying to bring the enterprise to profitability by means of various restructuring measures. The restructuring measures that the Bank AMCs are permitted to employ include the disposal of non-profitable assets and, where necessary, the restructuring of the companies, including mergers and acquisitions. Downsizing of the workforce, a highly sensitive subject in China, is not mentioned.

Mergers, virtually unknown under the pre-reform system of central planning, first appeared in 1984. Large-scale activity began in 1988. Government agencies state that 6.900 firms were acquired during the 1980s, involving total assets of RMB 8 billion (Asset Yearbook 1996, p.355). During the early 1990s, Asset Restructure Offices in Shanghai and four other cities, one government agency responsible for the restructure of state assets, assisted in transactions involving 2.900 firms and RMB 6 billion in assets (ibid.), implying a nation-wide transactions volume of roughly RMB 8.3 billion per year. The number of merger cases reached 20.000 in 1996. The volume of assets involved in merger and bankruptcy transactions jumped to RMB160 billion in 1994 (mergers only) and to RMB 415.5 billion in 1997 (Wang, S., 1998, p.150 and p.152; Industrial Development Report 1998, p.4 and p.8).

These figures indicate the volume of assets involved in mergers in 1997 is 100-fold of that in the mid-1980s and 1997. Despite this rapid growth, the proportion of assets subject to the change of ownership rights remains modest. In 1997, the volume of assets involved in mergers and bankruptcies throughout the economy amounted to 6,9% of the asset total of the state-owned industry and 3,8% of the asset stock of all state enterprises (Asset Yearbook 1997, p. 402). This amounts to approximately 2% of China's total reported industrial and commercial assets.

## 4.2 Mergers and Acquisitions in China's Stock Market

The Chinese stock market provides a stage for M&A where firms representing the most advanced and productive part of the economy can improve their competitive strengths. As such, they ought to take the lead in transforming the economy into a market-based system and in improving the industrial structure. M&A can play an important role in achieving this by improving the allocation of capital and in helping firms to grow and to strengthen their capabilities. Over time the stock market could develop into a real market for corporate control to discipline management.

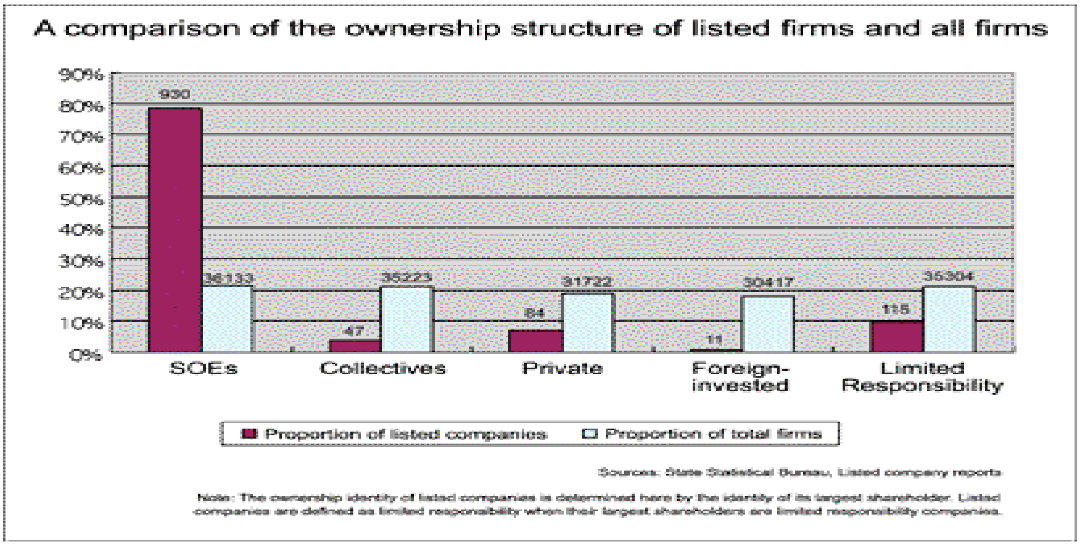
In terms of both their quality of management and their financial performance, listed companies out-perform non-listed companies. X. Zhang[12] (2003) completed a comparative study of the results of 1.000 non-listed firms and 1.170 listed firms. From 1996 to 2000, the return on equity (ROE) of listed firms was 6,8% point higher than that of non-listed firms. The better performance of listed firms is to a large extent due to the stock market's regulatory standards and the pressure exerted by regulators and investors. Despite this, listed firms still give cause for concern, especially in terms of their ownership structure and the types of industry in which they operate.

Amongst the five types of firms (state-owned, collective, private, foreign-invested and limited responsibility companies), the collectives and private firms are the most efficient ones. As Figure 4.1 and Figure 4.2 show, the percentage of SOEs in the stock market is very high: over 78% of the total of listed firms. The ROE of SOEs is very low, typically just over 1%, while private firms show an average return of over 5%. The challenge facing the China's stock market is thus huge.

[12] As the dean of Law and Regulation department in CSRC and the professor in Nankai University China, Dr. Xing Zhang supplied us a reliable information resource.

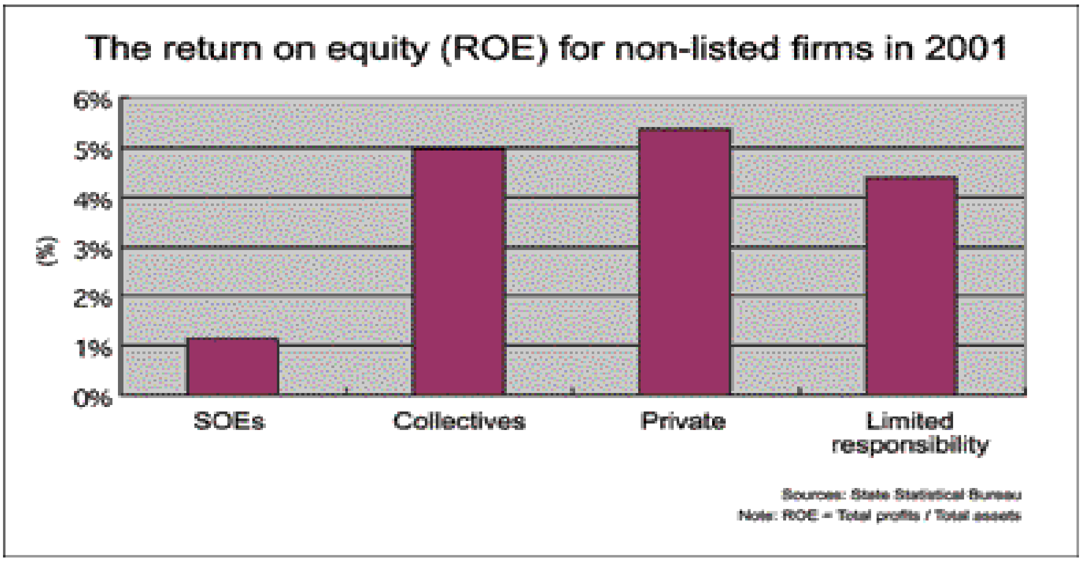
There are two ways to improve the quality of listed companies. One way would be to list more private and collective firms. But since stock market expansion should proceed gradually, there is an obvious limit to this approach. A second more practical way to improve the market would be to focus on restructuring, and improving the operations of firms already listed. This is where takeovers of listed firm could become useful (Zhang, X., 2002b).

**Figure 4.1 Ownership Structure in China**




Source: Zhang, X. (2003)

**Figure 4.2 The Profitability of the Firm in China**




Source: Zhang, X. (2003)

The M&A activities of listed companies have more economic impact than non-listed companies. Compared to non-listed companies, especially to SOEs, listed companies have the following characteristics: (1) All of them abide by general accounting principles, which are very similar to that accepted by business throughout the world; (2) Most of them are restructured out of former SOEs, and are trying to pursue profit according to the market principles, which are different from those followed by SOEs; (3) All the listed companies are shareholding companies. The ownership structure of these listed companies is clear and very similar to each other. Shares are divided into state-owned shares, legal person-owned shares and tradable shares. For most companies state-owned shares are the major part in the ownership structure; The Bureau of State-owned Asset Management (BSAM) holds these shares. There are two levels in the BSAM: provincial and state. SOEs and other shareholding companies usually own legal-person shares. The most distinctive characteristic is that state-owned shares and legal-person shares cannot be traded in the stock market right now. Exchange of this kind of shares is accomplished by agreement only. Only tradable shares, which are mostly owned by private or foreign individual investors, can be traded in the two stock exchanges; (4) Most of the listed companies have good performance records and are the leading players in their industries or in their provinces. Since the Chinese Stock Market is still in its testing and emerging stage, listing is strictly for good performing and well-restructured companies; (5) The government still has a great influence on these companies' activities, not only indirectly through industry policy, tax policy and accounting principles, but also directly through its role as a major shareholder in most listed companies. The Chinese government considers the listing as a good way to establish modern entrepreneurial mechanisms and to modify the debt structure of its SOEs. From a macroeconomic point of view, it is also expected that the market forces and the function of stock market can help to allocate resources more efficiently. So the government's shadow can be seen all over the stock market.

In September 1993, the first acquisition of a listed company through the secondary market was accomplished, and more have followed since then. Table 4.1 overviews the development of M&A in China's stock market from 1993 to 2003. It shows that more and more M&A took place after 1993. It is harder to measure the scale of M&A by its transaction value. The first reason is that a large part of M&A is free transfer, which means the government (usually the largest shareholder) reallocates the asset (state-owned shares) from the target firm to the acquiring firm. Then the transaction price is zero. The second reason is that there is no completed regulation for the disclosure of information related to M&A. A lot of listed companies did not reveal details about their transactions before 2000, such as the transaction value and the nature of the new largest shareholder.

**Table 4.1 M&A in China's Stock Market**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| The number of M&A | 1 | 6 | 0 | 9 | 33 | 70 | 84 | 103 | 119 | 168 | 166 |
| Transaction Amount (RMB bln) | - | - | - | - | 1.5 (24) | 3.8 (42) | 4.3 (47) | 4.9 (52) | 9.6 (68) | 14.3 (71) | 9.9 (68) |
| Private Bidder (%) | - | - | - | - | 21,2 | 21,4 | 21,4 | 29,1 | 29,4 | 33,9 | 52,5 |

* Figures in parentheses indicate the number of companies with detail transaction information.
** "-" indicates the data is unavailable.
Source: Calculated from *China Merger & Acquisition Review*, Vol.1 and Vol. 3, 2004.

**Table 4.2 Frequency Statistics of M&A in China's Stock Market (1997 – 2003)**

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|
| Free transfer | 7 (21,2%) | 18 (25,7%) | 30 (35,7%) | 27 (26,3%) | 25 (21%) | 29 (17,3%) | 39 (23,5%) |
| Legal Judge | 0 (0%) | 0 (0%) | 1 (1,2%) | 3 (2,9%) | 14 (11,8%) | 10 (6%) | 10 (6%) |
| Paid Transfer | 26 (78,8%) | 47 (67,1%) | 46 (54,7%) | 68 (66%) | 70 (58,8%) | 104 (61,9%) | 85 (51,2%) |
| Merging the holding Company | 0 (0%) | 4 (5,7%) | 5 (6%) | 2 (2,9%) | 4 (3,4%) | 11 (6,5%) | 14 (8,43%) |
| The restructure of holding company | 0 (0%) | 1 (1,4%) | 2 (2,4%) | 2 (1,9%) | 6 (5%) | 14 (8,3%) | 18 (10,8%) |
| Total | 33 | 70 | 84 | 103 | 119 | 168 | 166 |

* Figures in parentheses indicate the percentage of companies in the catalogue.
Source: Calculated from *China Merger & Acquisition Review*, Vol.1 and Vol. 3.

Table 4.2 shows the frequency of different types of M&As. The figure is slightly different from that of the M&A in a developed market, because of the different ownership structure of the Chinese listed firms. Chinese M&A transactions fall into five basic categories based on the types of changes of ownership of the firm: free transfer, legal judge, paid transfer, merging the holding company and the restructuring of the holding company. Free transfer means that a state-owned enterprise acquires the controlling rights of another state-owned enterprise free of charge. Legal judge means the acquiring firms get the controlling rights according to the court decision. Paid transfer is a payable transaction of the controlling rights. The acquirer may also indirectly acquire the target by merging or restructuring the holding company of the target. With the different nature of these transactions, each of them has different consequences with respect to legal obligations, acquisition procedures, and tax liabilities. The next paragraphs will focus on the free transfer and paid transfer, which account for the majority in all transactions.

Free transfer of state-owned shares is a very distinctive form of M&A in China. It means the government (usually the largest shareholder) reallocates its state-owned shares from the target firm to the acquiring firm. The main purpose of the transfer is to improve the efficiency of the target firms. The most remarkable case is the establishment of China Petroleum and Chemical Corporation (Sinopec Corp.). In 2000 the newly established Sinopec Corp. acquired four Chinese petrochemical firms – Yizen Petrochemical Co. Ltd, Jinling Petrochemical Company, Yangtze Petrochemical Group, and Nanjing Petrochemical Company. Sinopec Corp. and these four companies are all subsidiaries of China Petrochemical Group, the biggest Petroleum and Chemical enterprise in China. In order to support Sinopec, China Petrochemical Group transferred freely its majority shares of these four firms (about 86% of all shares) to Sinopec. The latter became the new majority shareholder of these four firms without paying one penny.

The advantages of the form of free transfer are (1) Under-performing firms can be restructured by bringing them under the management of efficient state shareholding companies. Meanwhile, this form of M&A can strengthen the competitive advantage of SOEs and help to foster growth in the leading conglomerate; (2) Theoretically, reallocating state-owned shares to another business entity can increase the value of state-owned assets, reduce the risk and improve the industry structure. Unfortunately, there is no research done to empirically support this proposition.

The method of free transfer is applicable for the following situations. (1) Shareholders of state-owned shares are the government agencies or state-owned shareholding companies. (2) There is a demand from the government to form a larger SOE. (3) The target is badly performing and badly needs the help of an efficient company that has a good management, technology and business strategy.

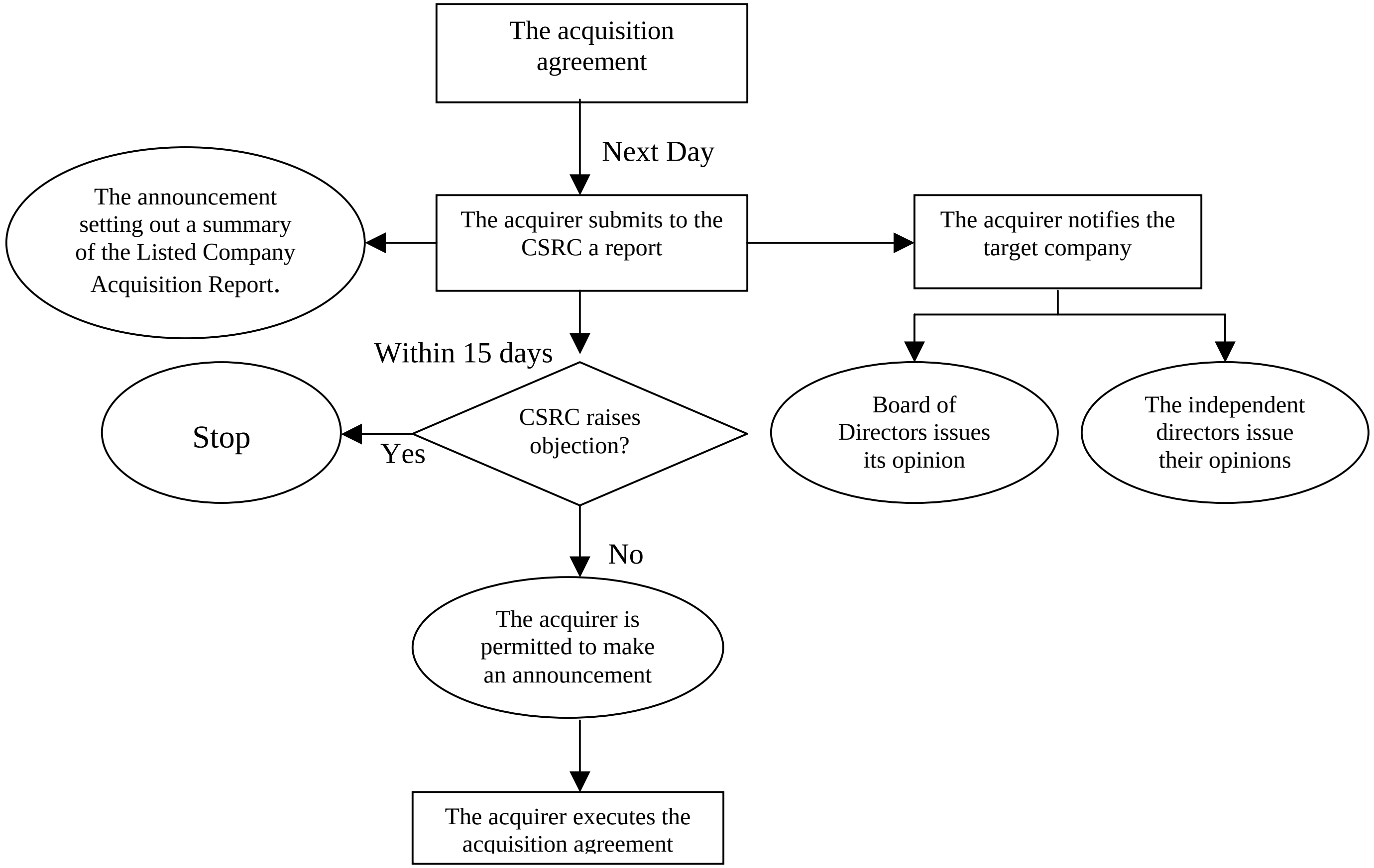
Paid transfer is the method to acquire shares in a listed company by means of a payable transaction in the stock market. It can be realised by an acquisition by agreement or an acquisition through the secondary market. The former means that the acquiring firm gets part or all the shares of the target through an agreement. The process is shown in Figure 4.3. Shares in such kind of transaction mainly refer to non-tradable state-owned shares and legal person shares. Because most of the listed companies have a high ratio state-owned shares and legal person shares, such a transaction has an important effect on the restructuring of SOEs and is subject to several regulations. For example, current laws state that state-owned shares cannot be sold to foreign investors. The sellers can cash out the non-tradable shares, reduce debt, adjust the investment structure and reallocate resources. The motives for buyers are: (1) The acquiring firm wants to achieve the majority shares and to restructure the target. (2) The acquiring firm wants to buy the "shell" source and wants to be listed. (3) Big shareholders are not satisfied with the performance of the target. For example, Eastern Computer, the largest shareholder of Yongzhongyuan, aimed at bringing its management, technology, and sales channels to the target. In May 1996, Eastern Computer increased its shares to 28% by acquiring the preferred shares[13], and became the dominating shareholder of Yongzhongyuan.

However, a question has been raised due to its non-tradable nature – how to value such kind of shares? Even though most transactions have already taken factors into consideration such as net asset value per share, return on assets, return on investment capital, market price and PE (Price to Earning) ratios, the actual price is usually a little bit higher than that of the equity. Because this approach of valuation ignores the value of brand names and of other intangible assets, most of the firms are greatly undervalued.

Stock acquisition in the secondary market is more like a hostile takeover. The first takeover case in China's stock market is in September 1993 by the private Shenzhen-based Baoan group that acquired the public Shanghai-based Yanzhong Ltd. by buying more than 20% of its shares through the secondary market and being the largest shareholder in the target. Unlike a mature market, stock acquisition through a secondary market is not the dominant procedure in the Chinese stock market.

[13] Preferred shares are stocks that are paid dividends priority over common stocks. Dividends may not be paid on common stock unless the dividend is paid on all preferred stock. Their dividend rates are usually fixed at time of issue.

**Figure 4.3 The Process of the Acquisition by Agreement**




Source: Zhang, X. (2002b)

Compared with other kinds of M&A, in China stock acquisition has the following disadvantages:

1. The cost is very high, because the bidder has to pay a market premium over the equity. Due to the regulations, the acquiring firm has to make a public announcement after each 2% increase of shares. This always makes the market price very volatile because it faces the possible resistance from the original shareholders and management or the competition from a rival. Stock acquisitions usually lead to hostile takeovers. This is more expensive than stock acquisition by agreement when only a small premium over the net equity is paid.
2. It is time consuming. According to "*Administrative Measures for the Disclosure of Information on Changes in Shareholdings of Shareholders of Listed Companies*" (2002), a person or firm, holding or controlling more than 5% of the total issued shares of a listed company, should submit a report on changes within three working days after occurrence of such change, and should cease purchasing or selling shares of the listed company two working days after the announcement (Article 17 and 18). So theoretically, it at least takes the acquirer one month before it acquires 30% shares of the target. If the acquirer holds or controls 30% of the total issued shares of the target company, he should make a general offer to all the shareholders of the target company to acquire all the shares held by them in the target company (Article 13).
3. In most listed companies the majority of these shares is non-tradable (state-owned shares and legal-person shares) and tradable shares make up the smaller part. So, only few companies can be acquired in the secondary market. The best way to buy them is to negotiate with the largest shareholder or with the government agency (the acquisition by agreement).

Above two forms are the two most important types. Meanwhile, China's regulation also allows other ways to acquire control of shares in the listed company such as shares transfer according to the order from the law court (such as confiscation, payment for a debt), merging the holding company and the restructuring of the holding company. But the percentage of these three forms is very low (Table 4.2).

## 4.3 The Institutional Environment of M&A

Many foreign economists considered the motives for M&A in China to be the improvement of Chinese business strategy and the attraction of foreign investment (Capener, 1998; Milman, 1999). It is true that M&A is important to implement development strategies and to gain a competitive advantage. According to Ross (2001), the possible sources of the advantages may fall into four basic categories: revenue enhancement, cost reduction, lower taxes and lower cost of capital. Increased revenues may come from marketing gains, strategic benefits and market power. Cost reduction can result from economies of scale, economies of vertical integration, complementary resources and elimination of inefficient management. The possible tax reductions can be realised via an acquisition to deduct losses from net operating results[14], the use of unused debt capacity[15] and the use of surplus funds[16]. The cost of capital can often be reduced when two firms merge because the costs of issuing securities are subject to economies of scale.

China's rapid growth and large market following accession to the WTO attract foreign investor interest. Foreign investment is more likely to consist of a takeover by a newly established joint venture, in which the foreign partner has majority control, or by a wholly foreign-owned enterprise (Capener, 1998). The foreign investor can purchase assets of a Chinese firm, or directly purchase shares in a listed (B shares) or unlisted company registered in China. M&A has become the lowest cost channel to enter into China's large market. For foreign investors in industries for which markets are very local, it is difficult to introduce a new product. Foreign companies may prefer then a merger or acquisition of an SOE to launch a new brand name in an often overcrowded and fragmented marketplace. Such an alternative allows foreign investors to capitalise on consumers' familiarity with existing local firms to build market share relatively quickly[17].

But it should be noticed that existing economic institutions have not been fully transferred into the ones of a "completed market economy" yet. M&A activity in China is hindered by a number of constraints. The numerous authorities involved in the approval process create confusion for investors. According to statistics from the Ministry of Commerce, only 1% of Foreign Direct Investment (FDI) in China took the form of M&A in 2002, compared with global M&A activities that make up 80% of total FDI throughout the world. Moreover, more than 50% of M&A deals in China ultimately fail (Gordon and Mackinnon, 2004). The absence of a well-functioning legal framework, managerial system and financial market, limit the effectiveness of M&A.

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[14] Tax laws permit the firm that has been profitable but has a loss in the current year can get refunds of income taxes paid in previous years and can carry the loss forward for later years. Thus a merger to exploit unused tax shields must offer tax savings over and above what can be accomplished by firms via carryovers (Ross, 2001).

[15] Because of the diversification after M&A, the acquirer might be able to increase its debt-equity ratio, issuing more debt and creating additional tax benefits.

[16] The firm might make acquisitions with its surplus funds. In a merger no taxes at all are paid on dividends remitted from the acquired firm.

[17] The increase in number of mergers and acquisitions (M&A) in China is impressive. According to Dealogic (a UK electronic database), China has been the fourth most important acquisition market in Pacific Asia in 2003 and 144 M&A deals by foreign companies were completed. Among recently announced ones is Kodak's further consolidation of its photographic film position in China by the acquisition of a 20% share in China's Lucky Film (the US firm paid US$100m for the stake). Then there is GE Power Systems' decision to buy 90% of a small-scale hydropower equipment supplier in Hangzhou.

### 4.3.1 The Legal Framework

In China, the rules governing listed company take-overs are still incomplete. The legal framework for mergers, acquisitions and restructuring is made up of a large number of laws, rules and regulations that govern different aspects of the market for corporate control. Each department and each region has its own regulations, which make M&A lack a uniform pattern (Zhang, X., 2002b). China's *Company Law* just gives us the definition of Mergers and Acquisitions, but there is no uniform "M&A Law". For SOEs, some special regulations stipulate 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 defence, high technologies, scarce mineral mining, and other specified areas, cannot be sold to private Chinese or foreign investors; (3) a state-owned enterprise in a strategic industry such as energy, transportation, or communications may only be partially sold, but a majority share must be retained by the government; and (4) every merger or acquisition deal of a large SOE that is the backbone of an industry must be reviewed individually. Those involved in the market face a lot of uncertainty, because of the lack of a consistent set of rules.

Things are different for a listed company because of the clearer property structure. The first relevant regulation, "*Interim Provisions on the Management of the Issuing and Trading of Stocks*", was issued by Order No.112 of the state council on April 22, 1993 and was implemented from the same date. It stipulates that (1) No individual is allowed to hold more than 0,5% issued by a listed company (Article 46). It means that no individual can acquire a listed firm. (2) If a legal person holds, directly or indirectly, more than 5% of the common shares issued by a listed company, a written report and announcement should be submitted to the listed company, the Stock Exchanges and the China Securities Regulatory Commission (CSRC) within three workdays. The legal person should announce every time when he increases or reduces his holding by 2% of the total amount of the shares issued (Article 47). (3) An investor who comes to hold 30% of the issued shares of a listed company shall make a takeover bid to all the shareholders, unless the securities regulation authority exempts him (Article 48).

Based on "*Interim Provisions on the Management of the Issuing and Trading of Stocks*", China's *Securities Law* went into effect on July 1, 1999. It firstly declares that (1) A listed company might be taken over by offer or by agreement (Article 78). (2) *Securities Law* omits the regulation that individual investors are not allowed to own more than 0,5% of the shares of a listed company; and it also treats both shareholders of common shares and shareholders of preferred shares as "Investors", who have equal rights and must fulfil equal obligations. (3) The benchmark of information disclosure increased from 2% to 5%. This greatly speeds up the M&A process in the secondary market, which is especially beneficial for the acquiring firm. Meanwhile, the *Securities Law* (Article 79) maintained the original regulations on reporting and information disclosure.

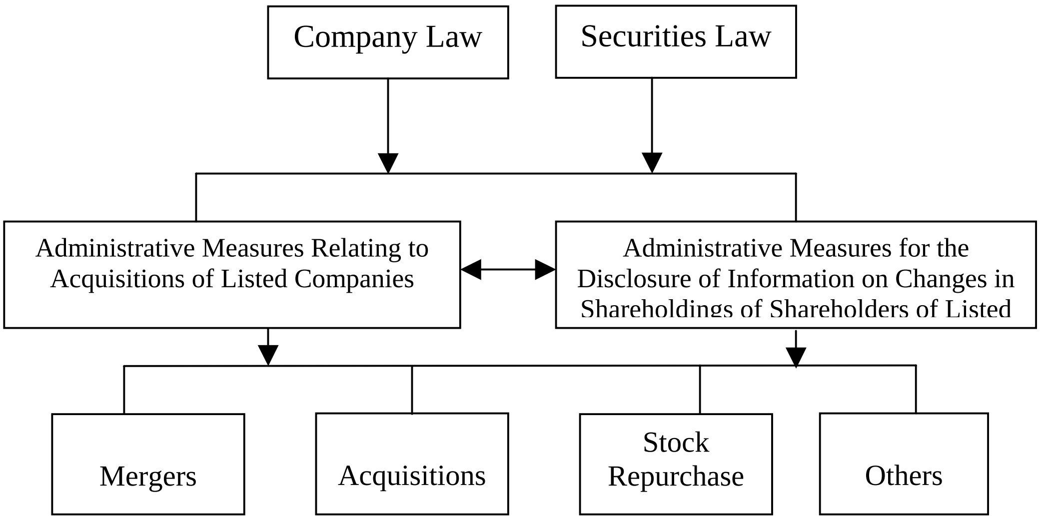
In 2000 some more detailed regulations were issued. For example, "*Regulation on Listed Company Takeovers*" is concerned with listed company sales, and contains a practical set of rules to govern general offers and negotiated take-overs. The "*Notice Related to Large-scale Sales, Purchases and Asset Restructurings of Listed Companies*" (Document No. 105) sets out the rules to govern the asset restructuring of listed companies. But there are still many questions to be clarified, such as how to determine the price. Because of the split between tradable and non-tradable shares, the valuation of non-tradable shares has become a hot potato to both the bidder and the target. It is also unclear whether a private company can acquire state-owned shares in a public company.

At the end of 2002, the CSRC issued "*Administrative Measures Relating to Acquisitions of Listed Companies*" and "*Administrative Measures for the Disclosure of Information on Changes in Shareholdings of Shareholders of Listed Companies*". The former breaks new ground in a number of areas: (1) there are no limits on what type of entity can engage in the take-over of a listed company. A state or private firm, an individual or a legal person, can all now get involved. But the measure does not make clear whether a foreign firm can directly merge with or acquire a Chinese public company. The authority is still working on some measures especially for foreign firms. By lowering the entry barriers, the rules should allow a larger and more diverse group of players to become involved; (2) more financial tools are available to purchasers. For example, a firm can now use shares or assets to buy a listed firm's shares, whereas before only large sums of cash could be used; (3) the pricing problem is resolved. The split between tradable and non-tradable shares (the ones owned by the state and legal entities) in China means that it is impossible to use market mechanisms to value the equity of listed firms. The new regulation allows for buying different types of shares at different prices.

"*Administrative Measures for the Disclosure of Information on Changes in Shareholdings of Shareholders of Listed Companies*" regulates disclosure of information related to changes in holdings of shareholders of a listed company. The measures ensure the information disclosure as required, protecting the rightful entitlements of investors and maintaining the normal order in the securities market. It regulates the form and the content of the announcement.

As shown in Figure 4.4, *Securities Law* and the "*Administrative Measures Relating to Acquisitions of Listed Companies*", together with other regulations, create a comprehensive and stable legal basis for the M&A market, which will undoubtedly stimulate its development, and will thus trigger a further consolidation in China's industries. But some questions are still waiting to be answered. For example, there is no law to regulate M&A that might cause monopoly. Drafting of the anti-trust law started since 1994, there have been numerous revisions because of controversies. The drawing up of such a law is part of China's commitment to the World Trade Organization (WTO). The decade-long drafting of the law is expected to be completed in 2004. On the other hand, while the CSRC is removing barriers with respect to listed companies, it is still not clear to the investors which law to follow when a merger involves both listed and unlisted firms.

**Figure 4.4 The legal framework of M&A for China's listed companies**




Source: Zhang, X. (2002a)

### 4.3.2 Acquiring SOEs, collective and joint stock firms

The administration by the government of M&A consists of all kinds of regulations concerning the target and acquiring firms. The management of state assets, which is mainly supervised by the Bureau of State-owned Asset Management (BSAM), is rather restricted by government rules and hinders the development of the M&A market in China. When the target is a state-owned enterprise, the deal should get the approval from at least seven government branches: the Ministry of Finance, the China Central Bank, the Economic Planning Commission, the Bureau of State-owned Asset Management (BSAM), the Administration for Industry and Commerce, the Department in charge of the industry of which the target company is part, and the Commission for Asset Restructure. If the acquirer is a foreign investor, the Ministry for Foreign Trade and Economic Cooperation (reorganised as the Ministry of Commerce in 2003) will also be included. For a publicly traded company, the Securities Regulatory Commission of China has a role to play.

In China the government is the representative of the state and controls 70% of the listed companies' equity and 80% of all listed companies. The question of who represents a SOE that is target of a 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 size and importance of the target company usually determines which level of the government is involved. A deal involving a small SOE, whose number of employees is less than 300, sales is under RMB 30 million, a value of assets is lower than RMB 40 million, and is controlled by the local government, can usually be approved of locally. A medium-sized SOE, whose number of employees is less than 2.000 workers, sales is between RMB 30 million and 300 million and the value of assets is between RMB 40 million and 400 million, 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 SOEs, whose number of employees is above 2.000, with sales above RMB 300 million and the value of assets above RMB 400 million, are under the direct control of the central government, and any merger or acquisition deal involving these companies will be carefully reviewed by the central government.

The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) issued a statute, which was effectuated on February 1st 2004, to regulate the ownership transfer of state-owned enterprises (SOEs). The document reasserts the central government's control in the M&As 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 BSAM, can represent a SOE in a M&A deal if the enterprise has not yet been converted into a joint-stock company; (3) a joint-stock company is the property of its shareholders, who have decision-making rights according to their shares, and the rights of the state shares are to be exercised by BSAM; and (4) the acquirer of a state-owned enterprise may be an individual or an institution.

Because of the high percentage of state-owned shares in listed companies, the government has made it clear that it intends to encourage the transfer of ownership into private and foreign hands and has experimented selling some of them by auction or selling them to the individual by allotment. On June 12th 2001, the State Council announced the "*Provisional Measures on Management over the Reduction of State Shares to Raise the Social-security Fund*". It is tried to sell state-owned shares to raise funds for the social security system. But the reaction from the market was very negative because of the potentially large supply of shares – the market value decreased about RMB 589.4 billion in one year, about 11% of total market value (CSRC, 2003)[18]. In the middle of 2002 the government had to suspend the action of the provision to sell state-owned shares to feed the social security fund. Up to now M&A seems the only way to reduce the state-owned share in SOEs, but it is as yet unclear when the procedure to implement such a policy will be fully implemented.

When the target is a collective enterprise, the matter is simpler. The collective company's ownership (TVE) is often vague and is usually controlled by the

[18] The real market value decreased more than this figure after considering 41 new listed companies during this period.

company's management while another company, a government agency, or a social institution acts in the name of its owner. 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 representative and a formal application with the government.

To acquire a joint-stock company, all an investor needs to do is to accumulate a controlling stake through stock purchase in the secondary market or by negotiation with the shareholders, a practice similar to that in most western countries.

### 4.3.3 The role of banks and stock markets

Unlike the industrial sector, China's financial system has always remained under the tight control of the government. It is still largely insulated from market disciplining mechanisms even after two decades of market reform. The instruments available for taking over companies are very restricted.

China's banking system consists of the central bank, policy banks (banks that carry out the government's industrial policy instead of pursuing profits), and commercial banks. They provide little service and support to the M&A transactions unless being directed by the government as in some rare cases in the past. According to China’s *Banking Law*, all Chinese banks are banned from getting involved in investment banking activities, which is why commercial banks will not finance the purchasing of the shares of the target company. Because of the lack of support of the banks, acquiring firms currently must use their own cash and this of course limits the scale of the deals they can undertake.

Two national stock exchanges were established in 1990. The securities market, however, is still in its developmental stage and each year limited quotas, explicit or implicit, are issued to the local government or industrial ministries for initial public offerings (IPOs) (Dong and Hu, 1995). To list on the securities markets, the company has to get the approval directly from the local government and other institutions in the central government. The result is that most listed companies are transferred from SOEs, which explains that the percentage of state-owned shares is extremely high. In China, equity ownership in a listed firm can have as many as four different classes: state-owned shares, legal-person shares, tradable A-shares and B-shares (which are only available to foreign investors and are traded in US or Hong Kong Dollars). It is common in Chinese listed companies that the percentage of tradable shares is very low. This forces the acquiring firm to turn to the government or state-owned holding companies to negotiate the transfer of the target firm's state-owned shares and legal-person shares. It is also difficult for a listed company to merge with other firms by means of issuing new shares unless a special approval of the government is received.

The development of M&A pushes the central government continually to loosen the institutional constraint for M&A. In recent years, several large securities companies have been established as intermediaries and were encouraged to play a role in M&A. They helped the acquiring firm to draft the plan for M&A and get acquisition financing. On the other hand, these large securities companies got the permission from the government to get banking loans. But the professional standard of the intermediaries involved in arranging M&As – the lawyers, accountants and investment bankers – is still limited. Most securities companies do not have a specific corporate finance department to handle M&A work, and in fact pay the sector little attention. One of the reasons for this is that corporate-related work is still a low fee generating business because there is little space left for them under the strict constraints. For example, the government controls most M&A cases and their transaction price. The M&A market is still subject to much manipulation (Zhang, X., 2002b). A rumour about a restructuring deal, or a fake deal, can push a company's share price sky high, and many securities companies have been involved in arranging such scandals. Most of the time, the corporate advisory staff within securities companies do little more than support those involved in manipulating a listed firm's share price (Zhang, X., 2002b). The CSRC has adopted a series of measures to avoid illegal actions and scandals, such as to strengthen regulation of information disclosure of listed companies, to improve corporate governance structures and to establish a quick response information regulation system. However, the regulation of listed companies is still constraint by many external factors, such as incomplete law enforcement means, which requires cooperation of other government departments, including judicial departments. The CSRC only has the power of administrative enforcement of law and can only give warnings or fines to parties in default. This has reduced the cost of irregularities, which is unfavourable to law enforcement. Insider trading and market manipulation are all criminal activities and investigations of the cases require freezing bank accounts, capital accounts and access to ID material. But the law provides that CSRC has no right to adopt compulsory measures on parties concerned that refuse cooperation. This has made investigations very difficult and sometimes even impossible. That is one of the important reasons why insider trading and market manipulation have frequently occurred.

The membership of the World Trade Organization (WTO) accelerated the development of M&A with foreign investment. For example, in the past, the Equity Change Regulations clearly prohibited the aggregate equity share held by foreign investors from falling below 25% of registered capital through acquisitions, unless all of the foreign party's interest is to be acquired by the Chinese party. But in late 1997, the Shanghai municipality issued a report entitled "*Several Opinions on Promoting Opening to the Outside World and Extending the Use of Foreign Investment*", recommending permitting foreign investors to acquire assets of a domestic enterprise through an investment in which they hold less than 25%. It eventually extended throughout the country. In 2002, the China Securities

Regulatory Commission (CSRC) and the People's bank of China (PBOC) released the "*Provisional rule on the Management of Investment in Domestic Securities by Qualified Foreign Institutional Investors*" (the "QFII Rules"), which took effect on December 1, 2003. It allows foreign financial institutions to invest in A-shares below the 30% benchmark via domestic securities companies and to repatriate profits out of China. At the end of 2003, thirteen foreign financial institutions got their QFII status with a US$ 17- billion investment limitation.

## 4.4 Driving Forces behind Mergers and Acquisitions

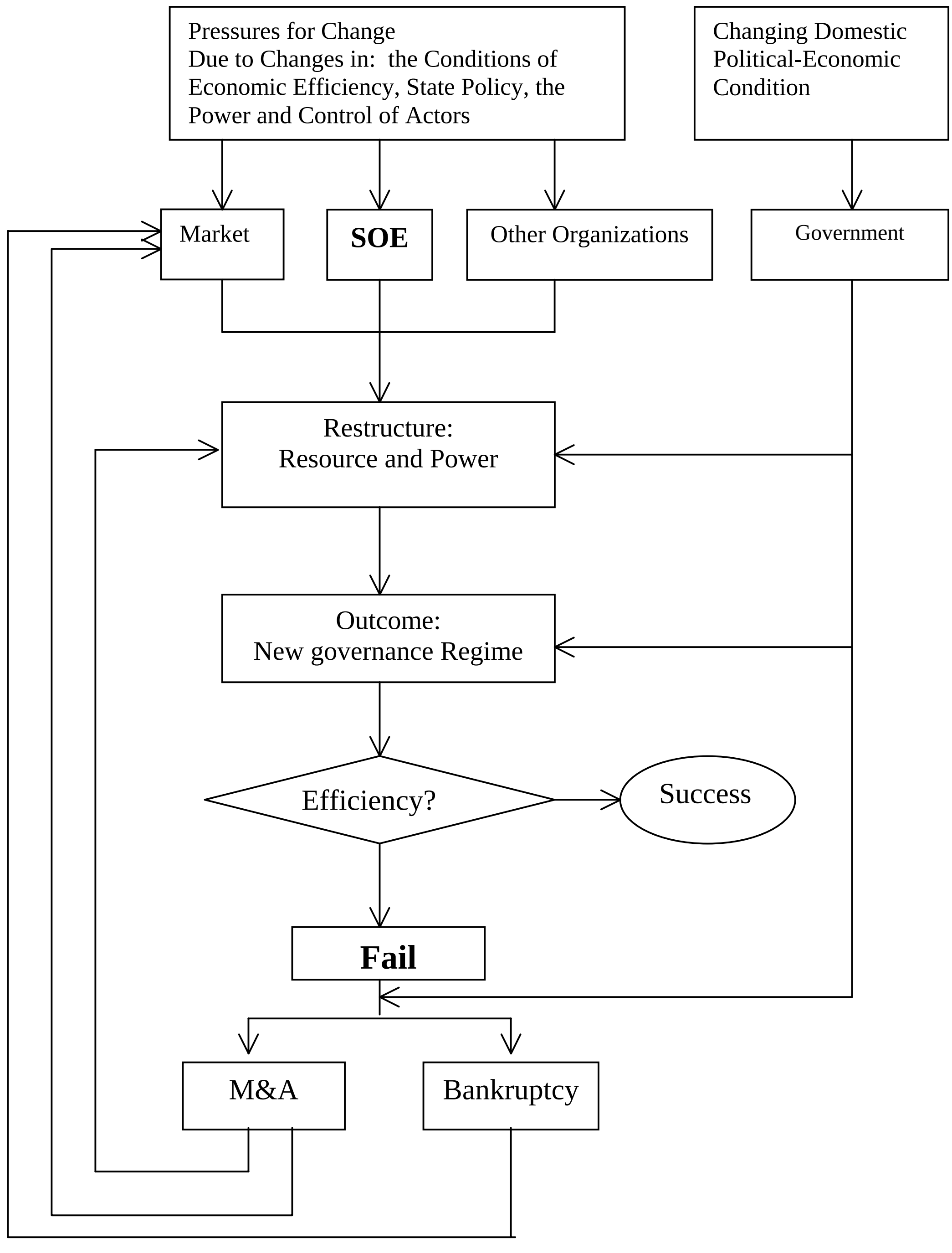
### 4.4.1 China's gradual reform approach

Institutional change is a complicated process because the changes at the margin can have large consequences for formal rules, informal constraints, and for the effectiveness of enforcement (North, 1990). Institutional change is a consecutive process instead of a discontinuous one creating new opportunities for organisations, which cause new changes, etc. Unlike Eastern European countries, which demolished the old institution swiftly, China has adopted a policy of reforming its institutions gradually. The new institution replaced the old one slowly mostly resulting in a "mixed bag of institutions". It seems to be the case in China that the choice for M&A and to limit bankruptcies as an instrument to transfer the economic system to a socialist market economy has reduced the cost of transaction and transformation substantially. The process is outlined in Figure 4.5, which is based on the model of Campbell and Lindberg (1991), in which insights from different social disciplines are combined.

The root of driving forces behind M&A came from the changing domestic political-economic conditions in China (top right box) pressing government to start the reforms. 25-year's reform certainly brought a great change to the institutional environment. Especially after the turning point of 1993 a big ideological breakthrough occurred after setting the goal for a socialist market economy. Both the informal institutions of values, norms and attitudes and the formal institutions of laws and regulations show major changes.

Changing domestic political-economic conditions pressed the national economic system, state policy, power and control of actors to be changed (top middle box). The new policy followed the "Coasian approach" in which decentralised bargaining leads to more efficient allocation. Since 1979, there has been a number of important developments in decentralising the coordination and decision making mechanisms. The development included accounting and auditing standards, codification of fiscal regulations, the creation of markets for labour and commercialised banking, the enforcement of debt obligations, commercial law, economic courts, securities markets, credit ratings and arbitration mechanisms. After 25 years of reform the national economic system has been gradually transformed from CPE into a "regulated" market economy.

**Figure 4.5 The Driving Forces behind M&A from the Reform**




Source: Based on Campbell, J.L. and Lindberg, L. N. (1991)

Under the new rules, the market was reshaped. The collective agricultural system has been replaced by a privatised system through the introduction of the household responsibility system. The success story in the area of industry is the development of non-state-owned enterprises versus the decrease of public ownership (see Chapter 3). However one of the most difficult tasks concerns the transition of SOEs 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 sufficiently off-setting the inefficiency of the SOEs, which contributes to rising inflation and eating away investment funds that might otherwise be effectively used.

For SOEs, decentralised mechanisms reduced the price distortion and moved prices closer to domestic and international value. It meant that profits and costs became better indicators of economic value. Beginning in 1993, the authorities required all SOEs to implement accounting procedures intended to bring financial records into conformity with international standards. On the other hand, despite these significant advances, China’s shift from plan to market was still under construction. The government still largely controlled investment spending, bank credit and the organisation of industry. SOEs’ management often consisted of bureaucrats of former government offices and colleagues of the enterprises previously attached to them. The great challenge of reform is how to revive those failing SOEs. A new governance regime of SOEs in China, what is the so-called "modern enterprise system", is urgently needed. It is required that resources and power inside the enterprise should be reallocated (the box of “restructure” and “outcome” in Figure 4.5).

Though some SOEs were successful in their transformation and improved their production efficiency, a large number of SOEs still kept their important role in the economy, but failed in their restructuring. Economists attributed an important part of their failure to their governance structure. Jefferson and Rawsk (2000) argued that ambiguous ownership and limited capacity for effective monitoring of enterprise assets was the fundamental cause of enterprise inefficiency and financial instability. “Ambiguous ownership rights blur incentives and erode monitoring capabilities, increasing the potential for inefficiency, waste, and organizational slack” (Jefferson and Rawski, 2000, p.3). Ambiguous ownership and ineffective monitoring led to the opportunistic behaviour by "workers, managers, and public officials, who extract value from the firm in excess of what they put in” (ibid, p.4). As explained, bankruptcy and merger are the two alternatives for SOEs (boxes at the bottom of Figure 4.5).

On the other hand, the rapid economic growth pushed the government to undertake a more fundamental, “deeper” reform of the economic system (the box of “government”). After more than twenty years of rapid growth under gradual reform policies that have sustained the dominant role of state ownership, China enters its new reform decade with a fundamental, deep ownership reform (Jefferson and Rawski, 2000). Developing mergers and acquisitions is one measure China has adopted to realise this change: an approach that differs from those of East European countries and the former Soviet Union in many aspects.

Russian government promoted a voucher program to privatise its state-owned enterprises. In November 1992 the Russian government distributed 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" (Sachs, 1992). In about one year, 7.000 Russian state-owned enterprises were privatised through the voucher auction (Nelson and Kuzes, 1994). (2) The program aimed at equity to be spread equally among all citizens giving an equal number of vouchers. (3) The program's single purpose was to achieve privatisation 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 (Nelson and Kuzes 1994). The voucher auctions have injected neither capital nor better management skills and technologies into the state-owned enterprises. Voucher privatisation left the old Communist-appointed managers in control of the newly privatised enterprises. As expected many did not know how to manage firms and to make a profit in a competitive market. As a result, privatisation has not improved productivity as expected. Black et al. (2000) reported that Russian privatised firms have cut their production by 50% and cut their employment by 10% since 1991. Many firms often did not pay their workers for months. The number of small Russian businesses dropped from 877.000 in 1995 to 829.000 in 1997. According to the statistics in the Human Development Reports 2003, from 1990 to 2001, Russia's average GDP per capita annual growth rate from 1990 to 2001 was –3,5%; there was 23,8% of the population living in absolute poverty, which reached its peak to 37% (about 55 million people) in 1999. Such a result should perhaps not be surprising in a country lacking to establish institutions - formal and informal ones - essential for a successful market environment (Dong and Hu, 1995; Black et al. 2000).

**Table 4.3 Pensions for Retired and Resigned Persons (RMB 100million)***

| Year | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|
| Total | 1043.6 | 1305.6 | 1552.2 | 1790.8 | 2073.7 |
| Paid by SOEs | 875.9 | 1093.1 | 1308.2 | 1517.6 | 1726.0 |
| Ratio (%) | 83,9 | 83,7 | 84,2 | 84,7 | 83,2 |

* Since 2000, the China Statistical Yearbook does not report the data by ownership; this figure presents growth rates only up to 1998.

Source: China Statistical Yearbook 1999

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 (Nelson and Kuzes, 1994), Chinese leaders seem to have taken another road. They tried to combine economic growth with the transformation of SOEs and adopted a policy of reforming them gradually, one by one. During the process the goals became more specific and more radical (to establish a market economy, to privatise SOEs, to allow entry to foreign firms, to introduce M&A, etc.). It was clearly a process in which trial and error was an important way to learn. The idea behind the mergers and acquisitions approach is to let the SOEs be voluntarily acquired by or merged with collective enterprises, private enterprises, and foreign investment enterprises. Such an approach has combined ownership transfer with management adjustments, technological upgrading, and capital injections (Dong and Hu, 1995). The gradual approach may help avoid the painful shock of finding the economic environment and reformed enterprises abruptly mismatched. The government has more time to tackle problems that may 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 SOEs (Dong and Hu, 1995), while the insider trading and the corruption may erode the state assets. It is too early yet to evaluate the virtues and vices of China's approach, but compared to the unsatisfactory results in Russia and some other Eastern European countries, China's M&A strategy seems to have a more bright future in reforming the state ownership structure.

During the process M&A was found to be a more effective tool over bankruptcy to reshape the governance structure in Chinese SOEs. Bankruptcy decomposes SOEs: different components are put into the market and recombined with other resources (the box of “bankruptcy” in Figure 4.5). China passed its Bankruptcy Law in 1986 for SOEs, but several factors hindered the implementation of the law and the bankruptcy experiment failed. The first reason is that there is no social security system for released workers. Bankruptcy threatens to put workers out in the streets creating accompanying social problems (Dong and Hu, 1995). In the traditional planned economy, it was the enterprise that took care of employee‘s social well being. After 1979 the social insurance system was set up gradually, but was far from completed yet. Bankruptcy provokes the question: who is responsible for the employees after their layoffs. In addition, SOEs have a much higher percentage of retired workers on their payrolls (Table 4.3). All these people depend on “their” SOEs for the rest of their lives. If firms go bankrupt these people are left to live on their own reserves. On the contrary, private firms and foreign-investment enterprises typically have a shorter history and younger workers, and hence the burden of pensions is not that heavy.

The second reason to prefer M&A over bankruptcy is because of the absence of a developed financial system, bankruptcies will increase the bad loans of China’s banks (Qian, 2002). Most SOEs are heavily indebted. In planned economies, firms received directly or indirectly via financial institutions a large sum of capital from the state-planning bureau. In the planning regime the relationship between firms and banks was comparable to the one between two departments in one company with close relations in the same network. If the firm could not payback the loan, the government would usually write it off (soft budget constraint). After 1979, both firms and banks were turned into separate profit-seeking entities. However, the old patterns are not eliminated immediately with the introduction of new formal rules. The value of collectivism in Chinese culture maintains the network relations between firms and financial institutions. Banks, especially state-owned banks, usually make the loan decision in harmony with the past relationships (*Guanxi*), or simply the order from the government is executed. This is a far cry from the profit seeking market-oriented way of doing business. It is estimated that about 80% of state-owned bank loans are allocated to SOEs (Qian, 2002). With the deterioration of SOEs, financial institutions face the danger that a large sum of loans will not be paid back. At the same time also a lot of debt between SOEs. It is obvious that one firm's bankruptcy will then threaten other SOEs and threaten related banks. So banks are willing to promote mergers as a means to strengthen firms and to reduce their bad loans. For example, China Construction Bank has helped to arrange 39 mergers among firms in the cement sector to prevent potential large amounts of bad loans, “slashing the non-performing loans ratio of cement makers from 80 percent in 1996 to 34 percent” in 2000 (Wang, Y., 2000).

The third reason to favour M&A is that there is a demand from private enterprises and foreign firms. In recent years, private enterprises and foreign investment firms developed very quickly and were viewed by the authorities as an important force in upgrading the economy, eventually absorbing excess labour in other sectors. But they needed more capital, more facilities, more technological skills and labour to support their business. In planned economies, SOEs often asked for a huge amount of excess physical resources because of their inefficient way of operations under the planning system. Excess resources in SOEs attract private enterprises and foreign-investment firms to merge with them.

In most cases, M&A does not decompose the enterprise but results in a restructuring (the box of “M&A” in Figure 4.5). The Chinese government believes that bankruptcy will bring instability to society and M&A is thought of as an effective approach to save these firms. They continue to urge the money-losing SOEs to merge with healthier enterprises. M&A is also welcomed and encouraged by the banks. So, at this stage of the transition, M&A is supported by all parties involved: government, banks and firms. But M&A is not a panacea, a universal remedy to every case. The effect of M&A should be tested in practice. For various reasons, many SOEs don’t improve their performance after M&A, and they will face the second round of choosing between mergers or to go bankrupt.

### 4.4.2 Business Competition

The growth of mergers and acquisitions is urged by the growing need of the enterprises themselves as they seek to implement their development strategies. All enterprises face fierce competition for their sales, for their managers and skilled workers, for their export contracts, and for their foreign connections. Industrial growth in the last two decades has brought the Chinese economy to a point to push for demanding an active M&A market that will facilitate its internal structural adjustments. 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” (Dong and Hu, 1995, p.19).

The development of China's M&A market helps enterprises attract more international capital (Ni and Zhu, 1994). Foreign investments in China usually take three forms: establishing and operating a new venture (joint venture or sole venture), investing in listed stocks, or acquiring or merging with an existing enterprise. Joint ventures are the most common form of FDI since 1979; because they involve the detailed operation of a project, the foreign investor usually needs to possess expertise in the particular business (Dong and Hu, 1995). Investing in the stocks of Chinese firms is a purely financial market activity but the investment targets are limited to the listed companies. With China’s membership of the WTO and the reduction of barriers of doing business in China, effective demand from the foreign sectors will surely grow. In particular, the opening of China’s financial sector to foreign participation will broaden the supply of funds to individuals and firms that can gain from property rights transactions (Jefferson and Rawski, 2000).

## 4.5 Concluding Remarks

China has adopted a policy of reforming its institutions gradually; M&A keeps pace with this gradual procedure. It started in China in the 1980s and developed strongly in the 1990s. M&A was initially introduced to reduce the number of money-losing SOEs. In contrast to bankruptcy, M&A does not decompose the enterprise but results in a restructuring avoiding unemployment and increasing NPLs. Also private enterprises and foreign-investment firms benefit from M&As to enter markets and improve their competitive position. As shown in Table 4.2, more than half of the bidders were privately owned firms in 2003. M&A has become an important means to change ownership in China from SOEs to non-state owned firms.

In the next chapter three empirical studies will provide more details on the motives and consequences of M&A in China.